

# EUROPEAN ECONOMY

COMMISSION OF THE EUROPEAN COMMUNITIES  
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**STABLE MONEY — SOUND FINANCES**

Community public finance in the  
perspective of EMU

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*European Economy* appears twice a year. It contains important reports and communications from the Commission to the Council and the Parliament on the economic situation and developments. As a complement to *European Economy*, the series *Reports and studies* will be published on problems concerning economic policy.

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**Commission of the European Communities**

# **EUROPEAN ECONOMY**

**Directorate-General for Economic and Financial Affairs**

**1993**

**Number 53**







# **Stable money — sound finances<sup>1</sup>**

## **Community public finance in the perspective of EMU**

*Report of an independent group of economists*

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<sup>1</sup> The opinions expressed in this report remain the sole responsibility of the group members and not that of the Commission and its services.



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## Preface

*The European Commission's Directorates-General for Economic and Financial Affairs and for Budgets asked a group of independent economists to examine the role of Community public finance in the perspective of economic and monetary union.*

*The group held four meetings under the chairmanship of Horst Reichenbach, acting Director of the Economic Service of Community policies at the Commission, who also contributed the 'Highlights' and 'Summary and conclusions'. Marc Vanheukelen was the rapporteur for Chapters 1 to 11 of the report. In addition, the group was supported in its work by contributions from officials in the Directorate-General for Economic and Financial Affairs — Antonio Cabral, Declan Costello, Alexander Italianer, Joost Kuhlmann, Knud Munk, Theodore Papaspyrou, Jean Pisani-Ferry, Pedro Santos, Manfred Teutemann, Rod Meiklejohn and Jim McKenna — and in the Directorate-General for Budgets — Jean-Pierre Baché, Charles Groutage and Daniël Hanekuyk. Valuable organizational and secretarial assistance was provided by Verena Barwig and Anna Maria Dürr.*

*This report draws heavily on the much larger body of analysis and evidence contained in a separate, supporting volume of individual papers entitled 'The economics of Community public finance', forthcoming in the series 'Reports and studies' of European Economy.*

*Heinrich Matthes  
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of European Economy*



## Abbreviations and symbols used

### *Member States*

B	Belgium
DK	Denmark
D	Germany
WD	West Germany
GR	Greece
E	Spain
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
P	Portugal
UK	United Kingdom
EUR 9	European Community excluding Greece, Spain and Portugal
EUR 10	European Community excluding Spain and Portugal
EUR 12–	European Community, 12 Member States including West Germany
EUR 12+	European Community, 12 Member States including Germany

### *Currencies*

ECU	European currency unit
BFR	Belgian franc
DKR	Danish krone
DM	German mark (Deutschmark)
DR	Greek drachma
ESC	Portuguese escudo
FF	French franc
HFL	Dutch guilder
IRL	Irish pound (punt)
LFR	Luxembourg franc
LIT	Italian lira
PTA	Spanish peseta
UKL	Pound sterling
USD	US dollar
SFR	Swiss franc
YEN	Japanese yen
CAD	Canadian dollar
ÖS	Austrian schilling
R	Russian rouble

### *Other abbreviations*

ACP	African, Caribbean and Pacific countries having signed the Lomé Convention
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities (SOEC)
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDCs	Less-developed countries
Mio	Million
Mrd	1 000 million
NCI	New Community Instrument
OCTs	Overseas countries and territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PPS	Purchasing power standard
SMEs	Small and medium-sized enterprises
toe	Tonne of oil equivalent
:	Not available

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## Highlights

1. In the perspective of economic and monetary union, European Community (EC) decisions on spending and its financing will be at the heart of policy-making. Even if the present EC budget is small (1,2% of GDP compared to the average of 48% of GDP for national spending in the Member States), these decisions have a profound impact on the principles of fairness, stability and democratic power-sharing.

2. With regard to policy-making, there are clear advantages with decentralization. The burden of proof should be on those proposing to centralize. The report acknowledges and welcomes the fact that this concern has been captured in the principle of subsidiarity as enshrined in the Maastricht Treaty on European Union, and it strongly recommends using the principle effectively as a safeguard against unwarranted centralization tendencies.

3. Concerning fairness, the report recommends that interregional solidarity should be expressed through Community public finance, i.e. that, on balance, resources should flow from richer regions of the union to poorer ones; the degree of explicit interregional transfers being largely a matter of political choice. While recognizing that strong political forces and Community objectives are at play, the economic case for a permanent and substantial increase in interregional redistribution, as a consequence of economic and monetary union, is found to be weak. Policy instruments for transferring resources must attempt to minimize the inherent dangers of interregional redistribution, such as distributional inertia, aid dependency, 'grantsmanship', moral hazard and economic inefficiency.

4. As to stability, the report comes to two main conclusions:

Community-wide stabilization should be achieved by the single monetary policy and the coordination of national budget policies. Effective policy coordination will be one of the main challenges in the future management of EMU. No explicit Community-wide stabilization role is foreseen for the Community budget.

However, there is a strong case for the Community to help Member States cope with severe specific shocks, which will become more difficult as, with a single currency, the exchange rate is lost as an adjustment instrument. Inexpensive and effective mechanisms, explicitly designed for stabilization, could be operated at EC level for assisting Member States hit by adverse economic developments.

5. With respect to democratic power-sharing, greater EC spending and revenue raising will require greater transparency and democratic accountability, and therefore a strengthening of the responsibility of the European Parliament in the budgetary field for spending as well as revenue raising. Further deepening beyond economic and monetary union and an enlargement of the Community to more than 20 members must be founded on a fundamental change in the constitution and the institutions of the Community.

6. Over the next few years, until the introduction of a single currency, a further step forward should be made in improving the economic efficiency of Community spending, in particular for the common agricultural policy and for economic and social cohesion. The common agricultural policy should be reoriented away from price support to direct income support, and also here, the principle of subsidiarity should be applied in a stringent way. The guiding idea for a further improvement in the operation of the Structural Funds is that they should become more performance-related rather than expenditure-related.

7. In the transition to EMU, the present financing system of the EC budget based on customs duties, agricultural levies, VAT and GNP will have to be continued; however proportionality should be secured, i.e. Member States should finance the budget in accordance with their share in Community GDP.

8. In the early years following the introduction of a single currency (i.e. in about 10 to 15 years) a small EC budget of about 2% of Community GDP is capable of sustaining economic and monetary union, including the discharge of the Community's growing external responsibilities (see Table 1). Such a budget should be composed of an effective interregional stabilization mechanism; reduced agricultural expenditure; an increased but still limited Community involvement in environment, R&D, trans-European networks and higher education; some further increase in expenditure for economic and social cohesion; and a strong rise in aid to third countries.

9. In economic and monetary union, the Community budget should be financed in a way different from the present one. European Central Bank profits are as convincing a candidate for new own resources. Other well-suited candidates are a tax on CO<sub>2</sub> emissions and corporate taxes. In the perspective of a truly single capital market, an overhaul of Community loan instruments appears necessary: the EIB should be entrusted with all project and programme financing and the Commission with borrowing and lending operations related to macroeconomic policy. There is an opportunity to step up Community lending to third countries, in particular to

Eastern Europe, where the Community's credit reputation could play a valuable role.

10. The accession of some EFTA countries is assumed in this report to have taken place before the introduction of a single currency. Further enlargement of the Community to the East is also becoming a pressing political priority, even if full membership of a significant number of countries might

still be far off. The main budgetary implications of such a further enlargement derive from the Structural Funds. On the basis of present per capita levels of cohesion assistance of about ECU 200 per capita per year to Greece and Portugal, an Eastern European population of 100 to 200 million inhabitants would require assistance of about 0,4 to 0,8% of Community GDP.

**Table 1**

**EC expenditure in the early years following the introduction of a single currency and comparison with the 1992 budget**

Expenditure categories	Indicative % of EC GDP	% share	1992 budget as % of 1992 GDP	% share in 1992 including EDF <sup>1</sup>
1. Agricultural expenditure	0,4 to 0,5	23	0,67	56
2. R&D, infrastructure, energy, education, environment	0,15 to 0,2	10	0,06	5
3. Structural expenditure (including Cohesion Fund)	0,4 to 0,5	23	0,32	27
4. External aid (including EDF <sup>1</sup> )	0,5 to 0,55	27	0,07	6
5. Expected outlays under regional stabilization mechanism	about 0,2	12	—	—
6. Other	0,1	5	0,07	6
<b>Total</b>	<b>1,75 to 2,05</b>	<b>100</b>	<b>1,19</b>	<b>100</b>

<sup>1</sup> EDF = European Development Fund.

## Summary and conclusions

### I — Scope and focus

The European Community (EC) is on its way towards the introduction of a single currency by 1999 at the latest. It has become a pole of attraction for many other European countries and has growing responsibilities on the international stage. The budgetary consequences of these developments, from an economic point of view, form the general subject matter of this report.

At present, the Community budget is very small, 1.2% of Community GDP, compared to the average of 48% of GDP for national spending by Member States. Without major changes, European economic and monetary union would therefore have a particular feature which is unique in history: a single monetary policy coupled with largely decentralized fiscal policies. One of the core issues for the future is whether European union will also need a big central budget, to make EMU successful and sustainable.

In addressing this issue, this report focuses on the minimum requirements for an economic and monetary union in terms of EC public finance. Consequently, a major part of the analysis is devoted to working out what the budget could look like in the early years following the introduction of a single currency. For the sake of convenience, full participation is postulated for all Member States and it is assumed that only some EFTA countries or countries with very small populations would have become full members of the EC.

The report briefly covers a longer-term perspective, including further deepening of European integration in terms of defence and social union and an enlargement of the Community to more than 20 members.

Recognizing the strong linkage between the political process in its various facets and Community responsibilities for spending and revenue raising, the report argues that deepening and widening of the Community will bring to a head the question of whether it is willing to adopt more direct democracy, and a European government in a long-term perspective.

Like its predecessor, the 1977 MacDougall report on the role of public finance in European integration, this report builds on and further develops the literature on the distribution of responsibilities between different levels of government. In addition, a significant part of the work has drawn on the rich experience of Germany, Switzerland, Austria, Canada, Australia and the United States. This is reflected

in a separate but supporting volume of individual papers prepared by members of the expert group and by Commission staff involved in drawing up the report.

### II — Past and present

Spending, and the financing of expenditure, are at the heart of democratic power-sharing, fairness and policy-making: the Community is no exception in this respect. In fact, Community finances have been an important institutional battleground between the two branches of the Community budget authority, the Council and the European Parliament, and budgetary fairness has been an important concern. Differing views of Member States on this question have given rise to serious tensions.

Table 2 provides a synopsis of current Community policies and their public finance implications. An analysis of the budget's present structure and past development reveals the following main features:

- (i) As far as spending is concerned, agricultural expenditure still makes up more than half of the Community budget and continues to grow at a rapid pace. This growth has occurred in spite of major efforts to reform the common agricultural policy since 1984. It also shows the limited effectiveness of the budgetary guideline for agricultural expenditure, which was introduced informally 10 years ago and which has become more binding since 1985.
- (ii) With the enlargement of the Community in 1981 to include Greece and in 1986 Portugal and Spain, structural problems and in particular regional disparities have dramatically increased. The Community has responded to this by substantially stepping up its efforts to assist backward and declining regions to cope with their situation, and to promote retraining of the unemployed and the modernization of the agricultural sector.
- (iii) There are some financial activities of the Community outside the general budget. These concern expenditure for development aid in the European Development Fund and for industrial reconversion in the European Coal and Steel Community (ECSC) operational budget. In addition, there are significant borrowing and lending operations by the European Investment Bank and others (ECSC, Euratom, balance of payments loans). The Community financial involvement in research, energy, industry, environment, and infrastructure is thus more important than the bare figures of the general budget might suggest. The same holds true for Community external assistance.



(iv) As far as the revenue side of the budget is concerned, the Community aspiration to be funded autonomously has largely failed. Unlike customs duties and agricultural levies, representing about one quarter of total

revenue, the VAT and GNP-based so-called 'own resources' are, from an economic point of view, effectively national contributions balancing revenue and expenditure in the general budget.

Table 2

The EC general budget, other expenditure and lending — Structure and development

	Million ECU	% of general budget	% of EC GDP	Average annual growth 1986-92
<b>EC general budget<sup>1</sup> (1992)</b>				
Agricultural expenditure	36 039	57,4	0,67	8,5
Structural expenditure	17 619	28,0	0,32	18,9
R&D, infrastructure, energy, education, environment	2 930	4,7	0,06	25,2
External aid	2 269	3,6	0,04	11,6
Other	3 971	6,3	0,07	-3,5
<b>Total</b>	<b>62 827</b>	<b>100,0</b>	<b>1,16</b>	<b>10,1</b>
<b>Other expenditure (1991)</b>				
European Development Fund	1 460	2,3	0,03	3,0
ECSC budget	500	0,8	0,01	12,1
<b>Lending (1990)</b>				
EIB	12 605	20,1	0,27	17,2
Other	1 017	1,6	0,02	-22,1

<sup>1</sup> Payment appropriations.

Sources: The EC general budget for 1992, *European Economy* 50, December 1991 and Supplement A, January 1992.

### III — General insights and recommendations

Against the background of past and present Community public finance, the report draws and enlarges on valuable theoretical and empirical evidence. However, the evidence cautions against a mechanistic view of further evolution. Much depends on the political process embracing the constitutional foundations, the rules of cooperation among the several levels of government, the characteristics of the democratic system and the sharing of power between the executive and legislative branches of government.

There is, thus, no prefabricated optimal model for the structure of economic and monetary unions in general and of the Community in particular. Nevertheless, theory and practice of intergovernmental relations provide some important in-

sights which have led the group to formulate general recommendations, relating to competences, stabilization and equity.

#### Beware of centralization

Even if, at present, federations function with strongly varying degrees of expenditure centralization, their historical development has provided ample evidence that the risk of ever-growing centralization is considerably greater than that of regions taking away power from the federal level. There are three main reasons for this: the desire for more power by the federal bureaucracy; the generally greater taxing powers of the federal level; and the growing importance of equity and stability objectives.

Clear advantages are seen in decentralization. Public goods and services can be tailored more to the preferences of the

population; democratic control is more effective, reducing the risk of excessive bureaucracy; and innovation and efficiency are encouraged through competition among jurisdictions. Consequently, the burden of proof should be on those proposing to centralize, and such proposals should be substantiated by a careful analysis of the benefits of centralization compared to its cost.

Benefits of centralization are likely to occur in the pursuit of a certain level of fairness or stability, when the policies in one jurisdiction have a positive or negative impact on well-being in other jurisdictions, and when there are economies of scale, including greater bargaining power, in particular *vis-à-vis* third countries. Even then, voluntary coordination might provide a more appropriate response than centralization.

The report acknowledges and welcomes the fact that these concerns have been captured in the principle of subsidiarity as enshrined in the Maastricht Treaty on European Union, and it strongly recommends using the principle effectively as a safeguard against unwarranted centralization tendencies. As far as spending is concerned, the proper application of this principle should give rise to an in-depth assessment of the cost and benefits of EC involvement.

### Positive integration

Applying the principle of subsidiarity, the report sees an economic rationale for some limited additional Community spending in: environmental protection; road, rail, telecommunications infrastructure and common energy carriers; research and development; and, to a lesser extent, higher education. Such Community expenditure could largely substitute for less efficient national spending and provide a positive integration complement to the completed internal market.

### External aid: growing strong

In existing federations, expenditure related to external policy is almost entirely carried out at the highest level. An important economic reason is that the advantages of external aid accrue also to neighbours, e.g. by helping to stem potential migratory flows. Coupled with greater bargaining power and efficiency considerations, this implies that an increasing proportion of third country assistance should be provided by the Community, which would thus be able to show that it has matured in terms of its international responsibilities.

### Criteria for revenue competences

With regard to revenue, apart from customs duties and central banks' profits, there is no important tax which is invariably allocated to the highest level of government in major federations. As federal practice offers little guidance, the case for Community involvement in taxation will also have to be based on a thorough analysis of its advantages and disadvantages.

In doing so, it is important to distinguish between EC responsibility in tax legislation and the allocation of taxes for the financing of the Community budget. The report focuses on the second question, in response to which the group recommends that the assignment of new own resources to the EC level should be guided by reference to one or more of three main criteria:

- (i) tax revenues are difficult or impossible to allocate between Member States (e.g. customs duties and central banks' profits);
- (ii) the tax base is highly mobile, implying that a low rate in one Member State, e.g. on capital income, erodes the tax base of other Member States;
- (iii) the tax is most effective in achieving agreed Community policy objectives (e.g. CO<sub>2</sub> taxes).

### Budgetary fairness and interregional transfers

Interregional solidarity should be expressed through central public finances, i.e. resources should flow from richer regions of the union to poorer ones. This resource flow principle does not pronounce on the degree of solidarity. In existing federations, explicit interregional transfers take place from richer to poorer regions through tax sharing, and general and specific purpose grants, even if as between countries, e.g. Germany and the USA, their intensity and composition differs. Through direct federal expenditure and social security and, to some minor extent, through the regional impact of taxation there are additional implicit flows of funds.

On the basis of this empirical evidence and Member States' sensitivity with regard to budgetary fairness, the report argues that the resource flow principle should, as a minimum, also be reflected in EC public finance. This is coherent with the objective of economic and social cohesion, the importance of which was underlined by the Maastricht Treaty on European Union.

The extent of regional transfers undertaken in applying the resource flow principle is a matter of political choice, which

should depend on an assessment of the distribution of the overall costs and benefits of integration; the scale and the effects of migration; the degree of homogeneity in terms of citizenship, culture and language; and the economic efficiency of the transfers.

On none of these grounds does European economic and monetary union, when established, call for a substantial permanent increase in interregional redistribution. A temporary special Community effort may be necessary as the costs of economic and monetary unification are high in the transition and fall to a greater extent on weaker Member States. However, in the final stage, poorer Member States are likely to benefit more than the richer ones, in particular from the elimination of transaction costs and exchange-rate uncertainty, as long as the loss of the exchange-rate instrument would be covered by the Community assisting them to absorb major shocks. Migration between Member States is unlikely to pose serious problems, given persisting cultural and language differences. In this respect, monetary union at European level is entirely different from the monetary and social union in the process of German unification.

Even though the economic case for greater interregional transfers in EMU is weak, the group none the less recognizes the political forces at play which are fuelled by three major sources: the longer-term trends in disparities, the decision-making process and the emerging European citizenship.

The explicit instruments for interregional redistribution should attempt to minimize the inherent dangers of interregional redistribution: distributional inertia preventing funds from being allocated according to changing needs; aid dependency leading to higher factor prices, hindering rather than fostering productivity gains and innovation; 'grantsmanship', profiting often richer and better organized recipients; moral hazard, i.e. creating eligibility artificially; and simple economic inefficiency, i.e. 'cathedrals in the desert'.

### Stabilization

In existing federations, central governments are responsible for fiscal policy, with their budgets regarded as a potential union-wide stabilization instrument alongside the single monetary policy. For Community-wide stabilization the monetary policy of the European system of central banks at EC level will be available in the same way as in existing federations. The group considers that, in addition, attention needs to be paid to the aggregate budgetary stance through the coordination of national budgetary policies. Making such coordination effective will thus be one of the main challenges in the future management of EMU. Nevertheless,

the group concludes that no explicit role in Community-wide stabilization needs to be foreseen for the EC budget.

In existing federations, the central budget has a significant regional stabilization effect. This takes place mainly through automatic stabilizers via budgetary flows principally serving other purposes, e.g. social security. There are very few explicit instruments designed to help regions in the case of economic difficulties.

The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting Member States to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for Member States to respect fiscal discipline rules.

## IV — A small 'EMU budget'

Based on these insights and recommendations, the report has focused on the necessary size of the EC budget after a single currency will have been introduced.

No necessity is seen for EC spending in a number of areas representing the bulk of central government expenditure in existing federations, namely on social security and welfare, defence, and general purpose grants. Moreover, since the EC also does not and should not in the future run deficits, interest payments on debt, which represent significant outlays in most federations, do not occur.

### A small budget will do

The central message of the report is that a small 'EMU budget' of about 2% of Community GDP is capable of sustaining European economic and monetary union, including the discharge of the Community's growing external responsibilities (see Table 1).

This is clearly contrary to much of the conventional economic wisdom, reflected in the MacDougall report as well as in the literature on economic and monetary union. Three distinctive features of this report compared to previous analyses explain the difference in the group's conclusions:

- (i) The principle of subsidiarity is applied rigorously.
- (ii) No explicit role is foreseen for the Community budget in Community-wide macroeconomic stabilization.

- (iii) While recognizing that strong political forces are at play and that the reduction of regional disparities is an important Community objective, the economic case for a permanent and substantial increase in interregional redistribution, as a direct consequence of EMU, is found to be weak.

### **Inexpensive but effective interregional stabilization**

Moreover, the group's confidence in this unconventional conclusion rests on one of its main findings. Inexpensive and effective mechanisms can be operated for assisting Member States hit by adverse economic developments (shock absorption) if they are explicitly designed for this purpose rather than being the automatic implicit consequence of much larger budgetary flows serving mainly other purposes as in existing unions. Such a shock-absorption mechanism would provide a cushion against adverse developments in the Member States to a similar degree as automatic stabilizers do, for example, in the USA. For a shock absorption scheme based on changes in unemployment rates, the group estimates that the average annual expenditure might be of the order of 0,2% of EC GDP.

### **Evolution of expenditure**

In addition to a cheap but effective specific stabilization instrument, no major new Community expenditure category would be necessary. However, the structure of expenditure should change significantly (see Table 2), leading to a drop in agricultural expenditure to about 25% of the total budget; an increased but still limited involvement (less than 0,2% of GDP) in expenditure on environment, R&D, trans-European networks and higher education; further strengthening of Structural Fund expenditure (including the new Cohesion Fund); and a strong increase in aid to third countries (including the integration of the European Development Fund into the general budget).

### **Revenue**

Here the following changes are advocated. New Community own resources should substitute, at least partially, for the present third and fourth resource, while at least maintaining proportionality, i.e. ensuring that poorer countries do not pay more and richer ones not less than their GDP shares. European Central Bank profits are as convincing a candidate for new own resources as customs duties. Other well-suited candidates are a tax on CO<sub>2</sub> emissions and corporate taxes.

### **Borrowing and lending**

By making a truly single capital market possible, economic and monetary union can be expected to reduce greatly the usefulness of and necessity for Community loan instruments for operations within the Community. A real overhaul of Community loan instruments would appear necessary in this context. The most rational way would be to entrust the EIB with all project and programme financing operations for structural improvements, whereas the Commission should continue to be responsible for borrowing and lending operations related to macroeconomic occurrences. The reduced relevance of Community loan instruments for internal financing provides an opportunity for stepping up efforts in third countries, in particular Eastern Europe, where the Community's credit reputation could play an invaluable role.

## **V — Towards EMU**

For the years leading up to the introduction of a single currency, the report advocates a gradual build up of Community spending towards the 'EMU budget' motivated case by case on the basis of the subsidiarity principle. On the expenditure side, economic efficiency should be improved, in particular for the common agricultural policy and the Structural Funds; for revenues, a fairer distribution of the financing burden should be assured.

### **Common agricultural policy: from price support to income support**

A decisive effort should be made to put the CAP on an economically sounder footing. The fundamental aim of the changes should be to separate the allocation and redistribution aspects of current agricultural policy. This implies a reorientation of the CAP away from price support to direct income support, which may be supplemented by national income transfers to farmers, subject to the fulfilment by beneficiaries of public tasks such as environmental management. This shift from price support (i.e. substantial transfers from the consumers to the agricultural sector) to direct income support from the Community and national budgets might require in the immediate future some increases in total budgetary outlays in order to make the policy reform politically palatable. However, over the medium-term such a reform would not only be beneficial from the point of view of economic efficiency, but should also lead to a reduction in overall budgetary outlays since the income support would become degressive and more and more targeted.

### Structural Funds: towards better performance

The report also argues for a significant improvement in the operation of the Structural Funds, including the new Cohesion Fund. The guiding idea is that they should become more performance-related rather than expenditure-related. Consequently, fixed *a priori* allocations to a Member State should be avoided and incentives provided for achieving verifiable targets. Such verification of performance should be carried out on three levels: first, the actual programme or project realization; second, the contribution to the overall improvement in structural adjustment; and third, the macro-economic policy achievements. The macroeconomic policy framework has been found to be of crucial importance for the effectiveness of structural assistance.

### Revenue: from regressivity to proportionality

As far as Community revenues are concerned, none of the three new own resource candidates advocated for full EMU can, technically and politically speaking, be made quickly available for Community financing. In the transition to EMU, therefore, the present financing system will have to be continued. However, it has a major defect arising from its regressive impact in relation to GDP on some Member States, i.e. poorer Member States tend to pay more than their 'fair' GDP share. The group strongly recommends that this defect be eliminated by securing proportionality, i.e. Member States should finance the budget in accordance with their share of Community GDP.

It is mainly VAT as the present third own resource which introduces very peculiar biases to Member States' financing shares. There are three broad ways in which the regressive nature of the present own resources system could be overcome. First, one could abolish VAT as an own resource. This has the advantage of clarity and simplicity but the major disadvantage of being a further step backward in terms of apparent autonomy in financing the budget, and it would close the door on VAT becoming a genuine own resource in the future.

The second pragmatic solution is a combination of VAT capping and a reduction of its weight in overall revenues. The drawback of this solution is that it goes only part of the way towards achieving the goal of proportionality. The third possibility would be to align Member States' actual shares in each year with their GDP share by offsetting payments and contributions in the subsequent year. This is a technically feasible and transparent way of achieving the desired objective, but would create some uncertainty and might, as a balancing item, create some political reluctance.

## VI — Further deepening and widening

In looking towards the longer term, beyond EMU, the report concludes that further expenditure requirements arising from economic integration alone should not be subject to a further quantum change beyond the limit of 2% of EC GDP suggested previously. Instead, the development of EC public finance in the longer term will be driven primarily by the implications of the intensification of efforts to construct a defence and social union as well as by the prospective enlargement of the Community towards the East.

### Defence and social union

In most existing federations, defence expenditure is 100% centralized (in Switzerland only 86%) and represents, on average, about 2,5% of GDP. There are very strong arguments for centralization in terms of the cost-effectiveness of military deterrence. A good economic case can thus be made for a fully fledged defence union, but this, of course, would imply a monumental change in perceptions of national sovereignty and therefore be politically highly controversial. Establishment of a rapid deployment force under the authority of the union in response to the needs for peace-keeping abroad, and for greater flexibility and speed, might be less objectionable. Its cost could be met by less than 0,2% of GDP.

While the concept and the economics of defence union are quite straightforward, the concept of social union and its economic and public finance aspects are highly complex. In fact, there are really two main aspects: the regulatory aspect of social union, and the fiscal aspect. The former relates to the Social Charter and is an essential part of economic union. This regulatory aspect need not have direct budgetary implications, and this is what has been assumed for the main thrust of the report.

However, in the longer run, two basic forces might lead to the necessity for the Community to give substance to the fiscal aspect of the social union. First, migration flows between Member States, motivated purely by tax or transfer considerations, would be economically inefficient and might call for intergovernmental grants, which have been demonstrated possibly also to be welfare-enhancing for the donor countries in such circumstances. Second, the feeling of common citizenship and solidarity might increase. This could imply that an unconditional fiscal equalization mechanism, as exists in most mature federations, might no longer meet with fierce political objections.

Finally, there is a risk that the wage demonstration effects will lead to higher unemployment, even if the combined

policy efforts of the Community and the Member States should be able to ensure that wage flexibility will become greater rather than smaller. Higher unemployment could increase the pressure for greater interregional transfers.

### Enlargement to the East

While these reflections on further deepening with regard to defence and social union are of a somewhat speculative nature, consideration of the further enlargement of the Community to the East will very soon become a pressing political priority even if full membership of a significant number of countries might still be far off. The main budgetary implications of such a further enlargement derive from the Structural Funds.

The eventual increase in budgetary outlays arising from enlargement to the East will depend crucially on how economically backward the new members are at the time of their accession, which in turn will be influenced by the amount of assistance they get before becoming members, and on how generous internal solidarity through the cohesion instruments will be when they enter. The future growth of internal spending in favour of economic and social cohesion and of external assistance to East European countries is thus of great relevance: the report calls for a balanced development with somewhat higher increases for external assistance.

On the basis of present per capita levels of cohesion assistance of about ECU 200 per year to Greece and Portugal, an East European population of 100 to 200 million inhabitants would require assistance of ECU 20 to 40 billion, i.e. 0,4 to 0,8% of Community GDP.

## VII — More democracy and a European government

Being composed of economists, the group felt that it had limited claim to expertise in the design of concrete proposals for institutional change. Nevertheless, the group is convinced that the public finance dimension of European integration is closely interwoven with the political process in its three main components: the constitution, institutional design, and decision-making procedures. The report therefore also contains some tentative reflections on directions for change in these areas.

Without pronouncing on the strong doubt that has been raised about the efficiency and democratic virtues of the Maastricht institutional and decision-making arrangements, the group considers that greater EC spending and revenue raising will require greater democratic accountability, and therefore a strengthening of the role of the European Parliament in the budgetary field. This should involve a greater say on expenditure where the present artificial distinction between compulsory and non-compulsory expenditure and the respect of the 'maximum rate' of increase in non-compulsory expenditure continues severely to marginalize the Parliament's role. In economic and monetary union the Parliament should also be given responsibility for raising revenues.

In the group's opinion further deepening beyond economic and monetary union and an enlargement of the Community to more than 20 members must be founded on a fundamental change in the constitution and the institutions of the Community. With regard to constitutional change, two ideas were considered. First, a popular referendum could provide the Community with an element of direct democracy which, if used for major policy decisions, could provide a good safeguard against undue centralizing tendencies. However, contrary to the experience of some small countries, a referendum at Community level would of course be a major operation involving heavy informational and administration costs. More importantly, this form of direct democracy squares badly with the traditions and experiences of some of the bigger Member States.

Secondly, a genuine participation of the European Parliament in intergovernmental conferences leading to changes in the Treaties would already be an important and necessary step for reinforcing the democratic legitimacy of the Community if Member States are unable to accept the suggestion that the European Parliament, in cooperation with national Parliaments, be entrusted with the task of working out a new European constitution.

Concerning the institutions, the group believes that in the longer run a genuine European government would need to be created based on a democratic system in which European-wide political parties have as strong an influence as national representatives, in other words the creation of a genuine two chamber system. This clearly corresponds to the federal view on European development which the group recognizes to be a long way from being a consensual one.

The report concludes that for the well-functioning of a further deepening of the Community and more acutely so for its inevitable widening it will be necessary to strengthen the democratic legitimacy of the Community and to improve present decision-making rules.





## **Part A**

# **Points of departure**



## Chapter 1

### General introduction

#### 1.1. Motivation of the report

All 12 Member States of the European Community have now ratified the Treaty on European Union agreed upon by the Heads of State or Government at the Maastricht Summit in December 1991.

The ratification period has been difficult for the European integration process, not only because of the temporary blow of the 'No' in the first Danish referendum, the small margin of victory in the French vote and the deep controversy in the United Kingdom over Maastricht, but also because the Community was confronted with a number of major and continuing challenges, such as the sharp recession and the concomitant rise in unemployment, the turbulence in the EMS and the conflict in the former Yugoslavia. Nevertheless, it also managed to achieve a number of important successes. The task of completing the internal market was virtually concluded, for instance, and the enlargement negotiations with several EFTA countries were launched.

Arguably, the most striking and definitely the most laborious achievement of 1992 was the Edinburgh agreement on the development of the EC budget for the period 1993-99, which should ensure a relative calm on the budgetary front throughout this decade, much as a similar agreement in 1988 did for the years up to 1993.

The Edinburgh agreement addressed the EC public finance requirements in the short to medium term, with regard to the new Treaty. It was the fruit of a pragmatic approach, taking account from the outset of what was politically feasible in a situation where national authorities faced considerable difficulties keeping their public sector deficits in check.

The present report, the writing of which largely preceded the debate that culminated in the Edinburgh agreement, deliberately keeps some intellectual distance from the politics that inevitably played a dominant role in the intense bargaining process. It attempts to provide an in-depth, long-term analysis of the functions to be discharged at Community level and the attendant size and composition of the EC budget in the perspective of EMU. The strength of the report, which is at the same time its weakness, is that it tends

to ignore national political interests and instead takes the need to maximize the welfare of the Community as a whole as its objective.

This report takes a fresh look into these matters. In 1977, the MacDougall report undertook a pioneering effort to assess in a systematic way the role of public finance in European integration. Building on an analysis of the role of the central budget in several federal and unitary States and on the insights from the available 'fiscal federalism' literature, the MacDougall report formulated a number of policy recommendations, in particular towards strengthening the capacity of the EC budget. Following these recommendations, the budget would need to grow to a minimum of 2 to 2.5% of GDP. Although it did not elaborate the matter at any length, given the breakdown of the first EMU attempt, the MacDougall group deemed that the budget had to be raised to 5 to 7% of EC GDP for it to be compatible with monetary union.

Despite the fact that little has come in the way of concrete execution of its policy recommendations, the MacDougall report can be seen as a benchmark for thinking about the EC budget because it took a far-sighted view and large parts of its analytical underpinnings remain valid. However, the normative economics of EC integration since the end of the 1970s have undergone appreciable changes as a result of, on the one hand, a better analytical grasp of and longer experience with the integration process itself, and of the altered views on the role and effectiveness of public economic intervention on the other. The debates on the contents and design of, first, an internal market, and, afterwards, an economic and monetary union, and the associated benefits and costs, have enabled a clearer insight into what EMU entails. The poor economic performance of most European countries between roughly 1975 and 1985 has prompted strong doubts about the usefulness of discretionary policy activism in the macroeconomic domain. Instead, the emphasis has come to lie more on the need for structural adjustment in goods and factor markets, leading to a reappraisal of the microeconomic responsibilities of government by way of the provision of public goods, deregulation or reregulation and incentives related to taxes and transfers.

This shift of emphasis has in several countries gone hand in hand with a decentralist tendency, which, apart from political motives, was inspired by a concern to improve the quality of government intervention. The recent past has thus been characterized in several Member States by a gradual diminution of the economic role of the traditional nation-State to the benefit of higher and lower levels of government. With federalism in vogue, there are no signs that this remarkable trend is about to be halted, let alone reversed. Yet, the

disarray in the former Soviet Union and the appalling events in the former Yugoslavia hold out a strong warning that a rearrangement of the distribution of power, let alone secession, has to occur in an orderly manner, reflecting a broad consensus among constituent parts.

Against the backdrop of these important recent developments, the present report essentially seeks to examine in a systematic way what economic policy responsibilities occasioning significant supranational expenditure need to be undertaken at the EC level in EMU and through what sources of finance should this expenditure be funded.

## 1.2. Scope of the report

Community public finance and European integration are indissolubly linked for both economic and political reasons. A deepening of economic integration calls for changes in the EC budget which, in the event that they are not introduced, may occasion systemic defects that threaten to undermine the *acquis communautaire*. The reinforcement of the EC budget may in turn be conducive to a further improvement of the functioning of EMU. Conversely, friction over the budget may paralyse the integration process, as was demonstrated by the protracted crisis of the early 1980s. The Fontainebleau accord of 1984 and the Brussels package of 1988 have proved to be among the key factors laying the foundation for the remarkable upswing in the integration process since 1985 and the successful implementation of the Single European Act notwithstanding the accession of Spain and Portugal, two relatively poor countries. By the same token, the new agreement for 1993-99 should facilitate the attainment of the Maastricht objectives.

Whilst the evolution of the EC budget should reflect economic imperatives, it is equally clear that at the same time it is an inherently political question as well, since the power to tax and spend constitutes one of the hallmarks of political sovereignty. Consequently, the volume, composition and financing of and the decision-making procedure regarding the EC budget also mirror the degree of acceptance of the emergence of a supranational level of government. Past disputes on the EC budget and their settlement have invariably displayed an important political dimension, and actual outcomes have often been different from what would be considered optimal from an economic point of view.

Although admittedly on several questions, such as the revenue-side of the budget and the streamlining of the budgetary procedure and framework, the distinction is not easy to make as there is an obvious interface between the two

aspects, the scope of this report is limited to the economics, not the politics, of the evolution of the EC budget.

As far as the report's time-horizon is concerned, a major part of the analysis covers the transition to EMU, and primarily the period beyond. Stage III of EMU can now reasonably be assumed to start in 1999, since a majority of Member States currently look unlikely to respect the Maastricht convergence norms by 1997. Hence, in calendar terms, the scope of this report covers the next 10 to 15 years. By virtue of the available literature on the economics of EMU and the fact that the nature of the EMU amendments to the Treaty has become fully clear following the wide debate on the consequences of Maastricht, it is possible to spell out rather precisely the structural characteristics and national policy constraints on which to base the discussion of the desirable properties of the EC budget once the single currency has been introduced.

The discussion with respect to what should happen thereafter, which is broached at the end of this report, will inevitably be more speculative as it depends on the specific choice of working hypotheses. Nevertheless, one can point to the probable budgetary implications of possible transfers of competences to the supranational level that are not strictly necessary for the viability of EMU.

Although this report is written from an economic angle, concrete policy recommendations, to be relevant, cannot be out of step with what is considered politically feasible. Policy recommendations will accordingly be formulated in a gradualist fashion, with more far-reaching proposals requiring higher degrees of political responsibility at EC level.

## 1.3. Definitions and basic assumptions

In order to avoid misunderstandings in the assessment of the analysis and recommendations that will be set out in the remainder of this report, it is important to be clear about the meaning of some key concepts as well as about a number of working hypotheses one needs to adopt on aspects of the development of the Community in the next 10 to 15 years that, while not strictly related to EMU, may impinge strongly on the future course of the EC budget. These hypotheses will be relaxed when the report is brought to a close.

This section deals first with the economic contents of EMU. It then goes on to discuss the 'social union' concept and its components, and formulates the basic assumption that the Community will not seek to establish any cross-border interpersonal transfer system in the period under consideration.

Subsequently, the report's hypotheses with respect to EC enlargement will be made explicit.

### The economic contents of EMU

Like other stages in the integration process, the basic definition of economic and monetary union is legal and institutional.

As to its economic meaning, there is a widespread consensus that a monetary union implies, pursuant to the provisions of the Maastricht Treaty:

- (i) the complete freedom of capital movements and a single market for financial services, including the total convertibility of currencies;
- (ii) a single currency (or at least the irrevocable locking of exchange-rate parities).

The first attribute formed part of the '1992' programme. The question of interest to this report concerns the policy implications at EC level of the pursuit of a single monetary policy geared to price stability and of the abandonment by individual Member States of the exchange-rate instrument.

The contents of economic union cannot be defined as clearly, because it involves policy interventions relating to different fields. It is also, by its nature, a more open-ended concept than monetary union, the need for measures at supranational level depending *inter alia* on the actual degree of integration of goods and factor markets, which evolves over time.

Economic union can be said to consist of four basic elements:

- (i) a completed internal market;
- (ii) competition policy and other measures aimed at strengthening market mechanisms;
- (iii) common policies aimed at structural change and regional development;
- (iv) economic policy coordination and assistance to achieve stable macroeconomic development, including rules on national budgetary policies.

In brief, an economic union is thus constituted by a single market flanked by a set of common policies (so-called 'positive integration') designed to reap all welfare gains from the existence of one market and one money (allocation and stabilization) and where all regions are given the opportunity to seize them (cohesion).

This set includes primarily EC interventions of a regulatory nature, such as competition policy, the harmonization or approximation of national rules, or the imposition of constraints on national budget deficits. However, as will be argued later on in the report, it also encompasses Community public interventions with a budgetary incidence.

### The concept of social union

Whereas in the case of the German unification process, the introduction of a single currency and common economic regulation was accompanied by the establishment of 'social union', it will be assumed in this report that the Community will not seek to pursue on the road to EMU those aspects of social union giving rise to explicit interpersonal redistribution across borders.

Social union is an even vaguer concept than economic union but it is taken here to consist of two main parts, one regulatory, the other financial:

- (i) the existence of a common set of minimum rights in the area of labour law;
- (ii) guaranteed union-wide minimum income or public service levels, and/or social security systems financed, at least partly, by central funding.

With a view to realizing the so-called social dimension of the internal market, which was given a more concrete shape by the 1989 Social Charter, the Community — probably without the UK as it obtained an opt-out on the social policy agreement in the new Treaty — is to adopt in the years to come labour market measures of a regulatory nature, although it should ensure that these do not hamstring the adjustment capacity of factor markets.

Observing the latter caveat, the Community may also wish, in a bid to promote the long-term upward convergence of social protection in the EC, to issue recommendations or even adopt directives setting norms — desirably country-specific — on minimum income levels and social security regimes, but the financial implications of any EC initiatives in this field are supposed to be borne fully by the individual Member States concerned.

This assumption is essentially inspired by the lack of any significant political support, especially in the northern part of the Community, for the creation of commonly funded welfare or social security schemes. This lack of support is very likely to prevail throughout the decade, in particular, in view of the growing political unease in richer regions of several individual Member States, such as Belgium, Ger-

many and Italy, about the working of national solidarity mechanisms. Neither will cross-border migration take on such dimensions that it will complicate in any significant manner the conduct of redistribution policy within Member States. In addition, as will be set out in this report, there are powerful economic and managerial reasons why inter-personal redistribution should remain a national competence. At the same time, it must be remarked that the absence of a Community-wide social security scheme poses a challenge for regional stabilization policy in EMU, to which the present report will map out a response.

### Community enlargement

Another important question on which working hypotheses have to be adopted is that of which European countries will become full members of the Community before EMU has reached its steady state. This question is both very complex and delicate as it bears on the fundamental issues of the ultimate destination and internal organization of the Community as well as of international relations in Europe in general. Whilst obviously lying beyond the scope of this report, one cannot ignore here the question altogether since the answer to it is clearly not without budgetary consequences.

Turkey, Austria, Cyprus, Malta, Sweden, Finland, Norway and Switzerland have already handed in their formal accession requests and several more applications are expected to be lodged in the coming years. Although, in the light of political events in Europe over the last five years, any hypothesis in relation to this issue is uncertain, it will be assumed that enlargement will be clearly restricted in number, with full accession being reserved to a limited number of EFTA countries or countries with small populations.

A combination of factors renders this assumption plausible. First, there is a long time-lag between application and eventual accession, the examination, negotiation and ratification stages jointly having taken up five years or more in recent cases.<sup>1</sup> Second, with the new Treaty on European Union leaving the institutional distribution of powers largely unchanged, a significant extension of membership would risk leading to the breakdown of the Community's decision-making process; there is a clear limit to 'widening' prior to institutional 'deepening' so as to reduce the weight of the intergovernmental dimension. Restoring the institutional balance is likely to be a key issue for the next intergovernmental conference due to be held in 1996 and it is only on

the basis of the outcome of that conference that the question of renewed widening can be tackled in earnest. Third, as far as countries of the former Eastern bloc are concerned, membership — entailing the acceptance of the entire *acquis communautaire* — can only be seriously considered upon successful transition from a command to a market economy. Although its duration differs strongly from country to country, this transition is bound to take a considerable number of years. Fourth, and related to the third factor, Member States may be reluctant to extend the Community to large and relatively underdeveloped countries because of the sizeable impact this would have on EC spending. By way of illustration, a back-of-the-envelope calculation suggests that the inclusion of Hungary, Poland and the Czech Republic could, with current cohesion policies, raise expenditure on the Structural Funds by about ECU 11,5 billion in 1992 prices, which would amount roughly to a 65% increase in present outlays on this item. This compares with approximately ECU 1,5 billion that these three countries received in 1992 from the Community and its Member States in the form of economic restructuring grants. Although aid to Eastern Europe will be stepped up in the years to come, the orders of magnitude of support to countries inside the Community as distinct from those outside will stay far apart. They may diverge even more as a result of the Edinburgh agreement because, whilst assistance to non-EC countries is to go up by 55%, structural operations are due to grow by 60%, with a further concentration of the means on the Community's least developed areas.

### 1.4. Plan of the report

This report is built up by means of four logically consecutive parts. Part A sets the general background by providing a concise account of the past evolution of the Community budget and its present economic characteristics.

Part B, comprising Chapters 3 and 4, examines in depth the implications of EMU for EC public finance. Chapter 3 reviews the theoretical 'fiscal federalism' framework in which these implications need to be studied, as well as the current distribution of spending and tax powers in mature federations. Chapter 4 addresses the key set of analytical issues of the report, centring around the question of what additional competences with a significant budgetary incidence need to be assigned to the EC level of government to ensure a properly functioning EMU.

The concrete, operational implications of the insights arrived at in Chapter 4 are elaborated in Part C, containing Chapters 5 to 10. The desirable development of Community expenditure of a regular, recurrent nature is discussed in Chapter 5,

<sup>1</sup> In spite of the pressure to accelerate the process, it is by no means a foregone conclusion that the entry of the most 'easy' applicants, Austria, Sweden and Finland, will take place any faster.



whereas outlays to improve resource allocation, spending on cohesion policy and aid to third countries are dealt with in turn. Chapter 6 concerns the question of macroeconomic stabilization and analyses the possible functioning of a Community financial support mechanism to assist Member States in their adjustment to country-specific shocks. It also assesses, on the basis of simulations, the appropriate annual budgetary envelope for interventions under such a mechanism. The sensitive matter of budgetary 'fairness' is broached in Chapter 8, setting out the advantages and disadvantages of various ways of ensuring that individual Member States' net budgetary benefits are broadly in line with their relative prosperity per capita levels. Chapter 9 concerns the role and

use of Community loan instruments and how they should change with the advent of EMU. Chapter 10 takes a look at some important regulatory and public administration aspects of the EC budget. It notably discusses in a nutshell the benefits and drawbacks of multiannual budgetary programming and ways to improve the decentralized execution of the budget.

Finally, the long term is contemplated in Part D, where the public finance consequences of the completion of social union and Community enlargement to Eastern Europe are briefly explored.



## Chapter 2

# The EC budget — past and present

## 2.1. The past development of the EC budget

In the first 20 years or so of the Community's existence, the evolution of the budget was determined by the quest for funding fledgling common policies, for financial autonomy, and for a balance between the institutions in the exercise of powers over the budget.

The foundations of the Community's main expenditure categories were laid during that period. The price guarantee and structural investment Funds (EAGGF) associated with the common agricultural policy (CAP) were created in 1962 and came into full swing at the end of the 1960s. As can be gauged from Graph 1, which portrays the evolution of the aggregate size and composition of Community spending over the last two decades, agricultural outlays accounted for more than 80% of the total in 1971. The Social Fund,

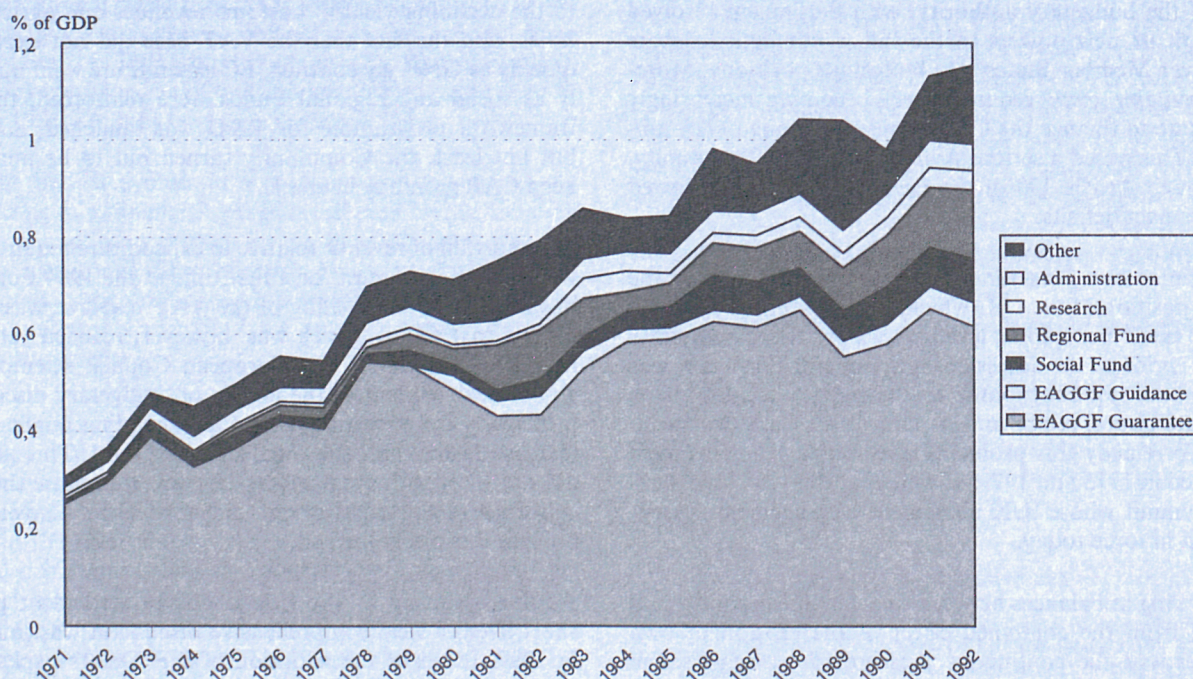
already written into the Treaty of Rome, was reformed in 1971 and given a strengthened role. The European Regional Development Fund was established in 1975.

From 1958 to 1970, the budget was financed by a system of Member State contributions, with the exception of the ECSC levy financing the coal and steel policy. In 1970 the system of 'own resources' was introduced, the revenue from which the Community became legally entitled to. They consisted of customs duties, agricultural levies, and the revenue of a 1% rate on Member States' VAT base. As indicated in Graph 2, the latter has soon become the Community's principal source of finance.

Under the provisions of the Treaty of Rome, the adoption of the budget was the exclusive prerogative of the Council. The European Parliament was given an important role by virtue of the 1975 Brussels Treaty. Since then the Council and Parliament form the two arms of the budgetary authority; the Parliament has the last say on some expenditure items (excluding the EAGGF) and can reject the budget altogether.

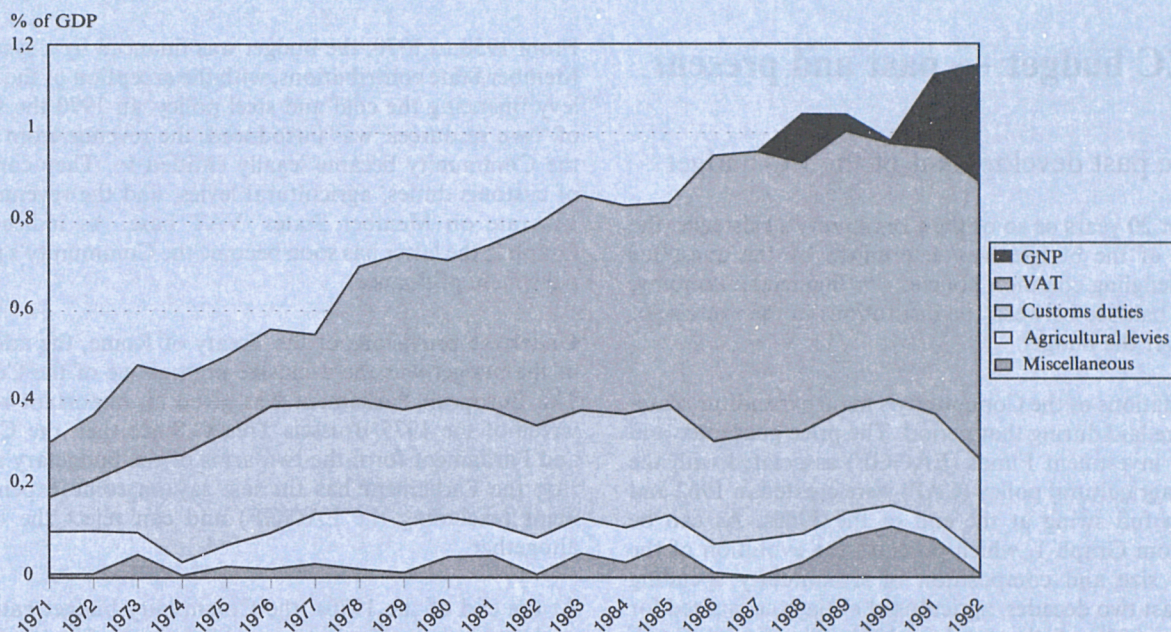
At the end of the 1970s, the Community budget entered a prolonged phase of crisis, caused by a host of factors. Aside

GRAPH 1: EC general budget expenditure





GRAPH 2: EC general budget revenue



from clashes of a more political nature between the two arms of the budgetary authority, with Parliament resolved to exploit its new powers to the full, a conflictual debate arose over Member States' net budgetary positions. Moreover, available own resources were becoming increasingly inadequate to finance the Community's growing policy ambitions. This posed a serious problem since the Community, pursuant to Article 199 of the EEC Treaty, is not allowed to run budget deficits.

The acrimonious *juste retour* debate was triggered by the specific position of the UK, which, notwithstanding the fact that its GNP per capita level lay below the Community average (prior to the accession of Spain and Portugal), was a substantial net contributor to the budget because of its small agricultural sector and its large VAT base relative to GNP. To remedy this problem, laborious agreements were concluded in 1975 and 1979, as well as at the 1984 Fontainebleau Summit whose 'UK abatement' arrangement is basically still in force today.

The growing imbalances between financial means and needs resulted from the combined effect of the erosion of own resources and the continuous pressure for strong rises in expenditure.

Revenue under existing own resources did not grow fast due to the declining yield of customs revenues and agricultural levies, and the fact that the VAT base did not expand as quickly as GNP. By contrast, EC expenditure went up steeply as social and regional Funds were reinforced, the first framework programme for R&D was launched, and, last but not least, the Community turned out to be unable to keep CAP spending in check.

The shortfall of revenue relative to expenditure requirements was tackled in earnest for a first time at the 1984 Fontainebleau Summit. The ceiling of the VAT resource was raised from 1 to 1.4% — which was, however, reached yet again in 1987. In addition, the European Council attempted to give a clear content to the notion of 'budgetary discipline', principally by stipulating that CAP spending ought not to increase faster than the own resources base. This attempt did not meet with great success, however, because the agricultural Council of Ministers did not feel in a position to observe this discipline rule.

As the adequacy of the Fontainebleau settlement proved short-lived, a new comprehensive discussion was launched in 1987. It led to the adoption of the 'Delors package' in 1988, to which both Council and Parliament subscribed by

way of an interinstitutional agreement. The economic goals of the 'package' were basically twofold. First, by covering the period 1988-92, it aimed at providing the Community with sufficient and stable resources to fund the implementation of the Single European Act. Secondly, it secured an agreement regarding the medium-term evolution of expenditure by means of, on the one hand, a translation in financial terms of policy priorities, and, on the other, the deployment of a more effective brake on the growth of agricultural spending.

## 2.2. The economic characteristics of the present EC budget

### 2.2.1. Limited room for manoeuvre due to legal and institutional constraints

The Community budget since 1989 is highly specific in that, as a result of an interinstitutional agreement of 1988 which is very likely to be renewed in 1993 for the period up to 1999, it is subject to a set of year-on-year constraints which strongly limit the scope for discretionary budgetary policy. The main aspects of this agreement can be summarized as follows:

- (i) The spending ceiling up to 1994 inclusive amounts to 1,2% of EC GDP, climbing gradually to 1,27% in 1999. The annual growth of agricultural expenditure (more precisely the guarantee section) must not exceed three quarters of GDP growth, such that the share of agricultural spending in the total budget, which stood at 65% in 1988, declines over time to below 50%.
- (ii) The budget evolves in a medium-term framework by means of a 'financial perspectives' plan laying down on an annual basis ceilings for the EC's principal expenditure categories (like agricultural support, the Structural Funds in their entirety, aid to third countries, or multi-annual grants such as those destined for research and development).

Besides avoiding recurrent clashes between the Council, Parliament and Commission which might otherwise cause political damage, the advantage of programming is that it permits a smooth development of the budget as the projected amounts in the financial perspectives are accepted as binding during each annual budgetary round. The drawbacks of the current regime are essentially twofold. First, as the framework does not only determine the real growth of the global envelope but also of its major constituent parts, transfers from one broad expenditure category to another are compli-

cated, imparting a degree of rigidity within the available means. Second, and most important, because the framework revision procedure is fairly cumbersome, the budget has difficulties in responding to unforeseen events, such as German unification, emergency aid to the former Eastern bloc, or the Gulf crisis. In any event, raising the ceiling on expenditure in the financial perspective by making revisions should not lead, in application of the principle of budgetary equilibrium, to a situation where the ceiling on own resources (fixed as a percentage of Community GNP) is itself exceeded.<sup>1</sup>

With multiannual programming, the Community has an open debate every five years or so on policy priorities and their budgetary translation, and some degree of automaticity in the intervening periods. An important question therefore is whether this medium-term approach is appropriate at the EMU-stage of integration or whether more flexibility is necessary, for instance to respond to economic and political contingencies inside and outside the Community. This issue will be dealt with in Chapter 10.

Apart from the foregoing limitations, it needs to be recalled that the Treaty forbids the Community to run budget deficits. Accordingly, the budget cannot play any significant stabilizing role for the overall EC economy.

Turning to the revenue side, the EC does not possess fiscal sovereignty, since the Community's budgetary authority has not been empowered to introduce taxes on its own initiative. The Community has four sources of finance. Besides customs duties, agriculture and sugar levies, and a tax of 1,4% maximum on a uniform VAT base, it can since 1988 call on a fourth own resource on the basis of GNP to cover the difference between expenditure and the receipts from the first three own resources. But any decision to expand or modify own resources requires the unanimous consent of the Member States. As a consequence, the current revenue composition does not stem primarily from optimal taxation considerations, such as economic neutrality or ability to pay.

### 2.2.2. The EC budget's specific economic incidence

As shown in Table 3, the 1992 budget totalled almost ECU 60 billion or roughly 1,1% of Community GDP, i.e. some 0,1% short of the expenditure limit. This year's budget looks set to use all the available resources, and care will

<sup>1</sup> The financial framework agreed at Edinburgh was built, on the basis of economic forecasts available at the time, in such a way as to have a margin of 0,01% of GNP between the ceiling of expenditure and that of own resources (i.e. less than 1% of total expenditure). The margin which was initially held back in the agreement of 1988 was 0,03% of GNP.

have to be taken not to go beyond the ceiling in the wake of the worse-than-expected GDP growth and the substantial changes in intra-EC exchange rates.

Using the familiar Musgravian triptych of public economic functions, this table suggests that the overwhelming part of spending goes to allocative policies, the more so as aid to the backward and declining regions through the Structural Funds takes mainly the form of action to improve local supply-side conditions.

However, this preponderance is primarily due to the expenditure associated with the CAP, which although being forced on a downward trend since the 1988 agreements, still absorbed in 1992 close to 54% of total expenditure (in favour of a sector generating less than 5% of Community value-added). Furthermore, notwithstanding the presence of allocative aims in its original mandate (Article 39 EEC) spending under the CAP has increasingly come to serve chiefly sectoral redistributive purposes in support of farmers' income and agro-industry (see Section 5.1.4).

Leaving aside agricultural support and the Structural Funds, EC expenditure for the promotion of the efficient allocation of resources is nearly ECU 3 billion. Although minor in absolute size, this amount is by no means completely negligible bearing in mind that, first, the principal policy instrument relative to allocation is regulation — which also explains why at the national level expenditure on so-called economic services does not account for more than 10% of the national budget — and, second, that in line with the subsidiarity principle (see Section 3.1.1) Community involvement in the provision of public goods and services as a general rule requires the problem at hand to exhibit a clear cross-border dimension.

More than two thirds of these ECU 3 billion are devoted to R&D support, equalling about 5% of what is spent to this effect by the Member States. The relative importance climbs to over 10% in three areas, namely energy research, R&D on infrastructure and general planning of land use and R&D on industrial production and technology.

The magnitude of current EC spending in other areas where the cross-border dimension is potentially large, such as en-

**Table 3**

**The composition of the EC budget 1991-93<sup>1</sup>**

	1991		1992		1993	
	Million ECU	%	Million ECU	%	Million ECU	%
<b>I — Expenditure<sup>2</sup></b>						
Agricultural policy	30 961	57,7	31 243	53,7	35 052	53,4
Structural operations	13 917	25,9	18 384	31,6	20 709	31,6
External policy	2 209	4,1	2 064	3,5	2 997	4,6
Research policy	1 706	3,2	1 945	3,3	2 201	3,3
Administrative expenditure	2 656	4,9	2 751	4,7	3 401	5,2
Other policies	2 146	4,0	1 759	1,3	1 161 <sup>4</sup>	1,8
<b>Total</b>	<b>53 650</b>	<b>100</b>	<b>58 147</b>	<b>100</b>	<b>65 523</b>	<b>100</b>
<b>II — Revenue</b>						
Agricultural and sugar levies	2 486	4,0	1 988	3,3	2 239	3,4
Customs duties	11 476	20,4	11 292	18,9	13 118	20,0
VAT	30 269	53,8	34 659	58,0	35 677	54,5
Additional resource (GNP)	7 445	13,2	8 322	13,9	14 030	21,4
Miscellaneous <sup>3</sup>	4 573	8,1	3 450	5,8	457	0,7
<b>Total</b>	<b>56 849</b>	<b>100</b>	<b>59 718</b>	<b>100</b>	<b>65 523</b>	<b>100</b>
<b>In % of EC GDP</b>		<b>1,06</b>		<b>1,11</b>		<b>1,20</b>

<sup>1</sup> The data for 1991 and 1992 are final outcomes; 1993 data refer to the budget as adopted.

<sup>2</sup> Payment appropriations.

<sup>3</sup> Includes mainly: tax and other deductions from staff salaries, interest on bank deposits and the remainder of the balance from the preceding year.

<sup>4</sup> Until 1993 national authorities were reimbursed part of the proceeds of own resources for covering their cost of collection. Since 1993 national authorities withhold this fee at source.

environmental protection or infrastructure, is hard to measure because it is scattered over a variety of budgetary lines. For instance, an important part of the R&D budget is directed to environmental and energy-saving technology, whilst a sizable portion of the Structural Funds goes to infrastructure works.

The explicit budgetary lines in support of these policies remain trivial, with token amounts that risk being too thinly spread to have any real impact. As far as environmental protection is concerned, this may no longer be the case when the sum is made of all scattered outlays. Spending on the environment then rises to about ECU 1 billion per annum, 1,8% of the total (statistical information on these matters is incomplete and not always comparable). Moreover, the European Investment Bank (EIB) gives loans to environmental projects to the tune of ECU 1,5 to 2 billion per year.

Apart from regional infrastructural assistance within the Structural Funds' envelope, current Community support for infrastructure networks such as rail and road transport or telecommunications, at about ECU 160 million, remains marginal compared to Member States' spending where the heading 'transport and communications' oscillates around 2 to 4% of GDP, or ECU 100 to 200 billion per annum. Yet in this respect as well the role of the EIB deserves to be mentioned, providing yearly ECU 2 to 3 billion of loan finance to transport and telecommunications projects in the Community.

Besides agriculture, and, to a much lesser extent, steel and coal, the Community does not pursue sectoral policies occasioning significant expenditure, it being understood, however, that the ECU 0,8 billion or so on R&D grants in support of industrial technology is liable to have a pronounced sectoral impact.

Finally, the large and increasing third-country component in the budget is worth noting. At about ECU 3 billion pencilled in for 1993, aid to third countries accounts for 5% of total spending, to which should be added the ECU 1,5 billion under the European Development Fund. The latter Fund is still kept outside the ordinary budget, *inter alia* because its mode of financing is different.

The Community budget cannot at present play any stabilization role for the Community economy as a whole for three reasons: it is of too small a size, it is prohibited from running a deficit, and due to multiannual programming it lacks the

necessary flexibility. In fact, the budget displays a procyclical bias in that its spending ceiling is expressed in Community GDP terms.

It cannot serve a regional stabilization purpose either for want of automatic stabilizers or other regional shock absorption instruments operating at EC level. In this respect, the Community differs markedly from mature federal and unitary countries where regional disturbances are to a significant extent (see Section 4.2.2) offset through the national direct tax and social security system.

The EC budget's general redistributive capacity is weak. Its redistributive impact is essentially determined by three factors: a country's contribution to the Community's VAT receipts, the share of agriculture in national GDP, and the interventions of the Structural Funds, which exhibit a strong geographical concentration.

Operating by way of specific-purpose (and thus conditional) matching grants, the Structural Funds transfer quite important amounts to some parts of the Community, notably the small less developed Member States: the grants received in 1992 by Ireland, Portugal and Greece each represented more than 2,5% of GDP, equivalent to more than 75% of gross fixed capital formation by the public sector.

Although, as will be pointed out in Chapter 8, it is difficult (and also politically very delicate) to calculate its effective incidence on Member States since several expenditure and revenue items cannot be assigned to specific countries, the EC budget has in the past been criticized (notably by the UK and increasingly Spain) for not being 'fair', the principal distortion arising from the disproportionate share of agriculture. Thus, whereas, the budgetary 'bottom-line' for Ireland and Greece is very positive (net receipts exceeding 5% of GDP) it is already much less the case for Spain and Portugal, in spite of the fact that the latter is clearly poorer per capita than Ireland. For the same reasons, Denmark and the Netherlands, enjoying a higher than average GDP per head, used to be net beneficiaries until the recent past.

The 1984 Fontainebleau settlement of the British budget problem, which provided for a special arrangement on the revenue side, was largely maintained in the 1988 own resources decision. As a consequence of this arrangement, the UK now contributes in net terms approximately 0,4% of its GDP, instead of 0,6% otherwise. More generally, the regressivity of the revenue side has been mitigated since 1989 by the rule that the VAT assessment base to which a rate of 1,4% is applied, is capped at 55% of national GNP.



### 2.3. The 'Delors II' package and the Edinburgh agreement

As the 1988 accord expired after five years, a new general debate on the future of the EC budget was called for in 1992. Initiated in February by Commission proposals known as the 'Delors II package',<sup>1</sup> the debate was founded on the need to provide the financial means for realizing the Community's enhanced internal and external ambitions following the successful conclusion of the new Treaty and the events in Eastern Europe. Throughout, the debate was strongly influenced by concern not to imperil the ratification process in Member States with a hesitant public opinion on Europe, and by the rapidly deteriorating economic situation and the state of national public finances. As it contains little or no provisions with a clearly quantifiable budgetary incidence, the Treaty did not entail any automatic or obligatory financial consequences. Thus, one cannot consider the agreed increase in the budget from now until 1999 to be the 'invoice of Maastricht' although the media often presented it in this manner.

The initial plan of the Commission proposed the conclusion of a new five-year accord (1993-97) during which maximum Community spending would increase in real terms from ECU 63 billion in 1992 to ECU 83 billion in 1997, requiring a rise in the own resources ceiling from 1,20% to 1,37% of GNP. The extra money was essentially to serve three purposes. In keeping with the reinforced emphasis on economic and social 'cohesion', as reflected in the protocol to that effect of the new Treaty, half was to be devoted to a rise of expenditure on 'structural operations', so as to reach approximately ECU 30 billion in 1997. A second priority was to strengthen the Community's role on the international scene by a 75% expansion over the period of the EC's envelope for external aid. With a view to bolstering the competitive position of European industry, the third area to be privileged was that of spending on research and development, as well as the deployment of trans-European networks, the supranational competence of which has been foreseen in the Maastricht Treaty (Articles 129b to 129d). The cohesion protocol also was the chief source of inspiration for the Commission's ideas with regard to the revenue side.<sup>2</sup> It was proposed to increase the role of the GNP-based own resource and at the same time to lower that of the VAT-based own resource. No candidates for a new own resource were put forward.

Member States responded rather favourably to the external assistance part of the Delors II package, but considered the expenditure plans in support of competitiveness to be over ambitious. They were clearly divided over the proposals to raise considerably the Community's structural outlays.

As the economic downswing took hold in more and more countries and national public finances came under strong pressure, rendering future compliance with the 'excessive deficit' criteria of Maastricht increasingly problematic, a number of Member States argued for a closer parallelism between the pace of expansion of the EC budget and their own public spending. They criticized the proposed increase in the own resources ceiling as being too high, which prompted the Commission in November to extend the time-frame of the requested rise in expenditure to 1999.

In the event, the Edinburgh Summit of December 1992 managed to reach a unanimous position on the development of the EC budget until 1999, the main ingredients of which are presented in Table 4. The last row in the table indicates the overall constraint imposed on the budget with the own resources ceiling staying unaltered until 1994, and growing very gradually thereafter to 1,27% in 1999.<sup>3</sup> Expenditure was classified into six broad headings, each being subjected to specific annual expansion limits. The first relates to agricultural spending, where the aforementioned guideline according to which outlays on agriculture must not increase by more than 74% of Community GDP growth continues to apply. In fact, the spending curbs on agriculture were tightened as a number of expenditure items that used to be outside the coverage of the guideline (e.g. income support, market support measures for fishing) will now be incorporated.<sup>4</sup> The budgetary consequences of the CAP reform agreed in 1992 and the inclusion of the new German *Länder*, estimated in 1992 prices at approximately ECU 1,5 billion by 1999, will thus have to be borne by the available resources under the guideline.<sup>5</sup>

<sup>1</sup> The Commission proposals were first presented in the communication 'From the Single Act to Maastricht and beyond' (COM(92) 2000), and detailed in 'EC public finance between now and 1997' (COM(92) 2001).

<sup>2</sup> The protocol provides that greater account should be taken of the contributive capacity of individual Member States in the system of own resources.

<sup>3</sup> The successive sum totals of payment appropriations were based on a GDP growth hypothesis of 1,1% in 1992, 1,4% in 1993, 2,2% in 1994, and 2,5% thereafter.

<sup>4</sup> This measure did not pose a major political problem as hitherto actual spending under the CAP fell short of the allowed maximum by a fairly wide margin, largely because the base year of the guideline proved to be generous.

<sup>5</sup> The Edinburgh Summit also extended the purpose of the monetary reserve under the sixth heading. Until now, this reserve was meant to cushion the adverse consequences for agricultural spending resulting from dollar/ecu exchange-rate changes. The reserve can in the future also be drawn on to fund extra CAP spending owing to exchange-rate fluctuations between EC currencies. Because of the use of the costly switch-over system which raises agricultural expenditure following an appreciation of a national currency *vis-à-vis* the ecu, it remains to be seen whether this extension of the reserve's task is consistent with halving its volume as of 1995.

Despite deep initial divisions over the Commission proposal, the projected expenditure for structural operations was raised very considerably and the expenditure foreseen by the Commission for 1997 will effectively be reached in 1999. The regions with a GDP per capita below or close to 75% of the EC average will enjoy a two-thirds increase in Structural Fund transfers.<sup>1, 2</sup> By virtue of this increase and the creation of the Cohesion Fund pursuant to the provisions in the Maastricht Treaty, Greece, Portugal, Ireland and Spain will altogether receive (in 1992 prices) twice as much from these EC structural operations as in 1992, implying an almost

fourfold expansion since 1988.<sup>3</sup> Structural Fund outlays for other purposes are to rise by nearly 50%. The overriding attribute of the Edinburgh agreement is therefore the important reinforcement of the EC budget's redistributive dimension.

As to spending related to internal policy, consisting principally of expenditure on R&D, the environment, trans-European networks of transport and communications, and education, Member States decided to allow for a 30% increase over seven years, compared to the 50% requested by the Commission. R&D should take up between one half and two thirds of the overall figure under the 'internal policies' heading.

Starting from a low level, assistance to third countries will grow by more than 40% to ECU 5,6 billion in 1999, to which should be added the reserve set up to cover the cost of unforeseen emergency relief. A supplementary ECU 300

<sup>1</sup> In addition, the transfers to the new German *Länder* will be adjusted upward such that the latter receive similar treatment on a per capita basis to the other lagging regions of the Community.

<sup>2</sup> The increases in spending agreed at Edinburgh are generally expressed *vis-à-vis* the level of 1992. However, in the case of structural expenditure, this is somewhat misleading because in 1989 the envelope for the Structural Funds was fixed for the period to 1993 inclusive. Apart from determining the size of the Cohesion Fund, operative since 1993, the Edinburgh agreement relative to the Structural Funds therefore pertains *de facto* to the period 1994-99. If one takes the difference between 1999 structural spending as foreseen in the Edinburgh financial perspectives and 1993 expenditure as planned in real terms in 1989, i.e. without the Cohesion Fund, the increase in structural outlays amounts to 51%.

<sup>3</sup> The establishment of the Cohesion Fund is stipulated in Article 130d and is designed to contribute to projects in countries, as distinct from regions, with a GDP per capita of 90% below the EC average in the fields of environment or transport infrastructure forming part of trans-European networks.

**Table 4**

**Financial perspective for 1993-99 as agreed at the Edinburgh Summit on 12 December 1992**

(appropriations for commitments — million ECU, 1992 prices)

	1993	1994	1995	1996	1997	1998	1999
1. CAP	35 230	35 095	35 722	36 364	37 023	37 697	38 389
2. Structural operations	21 277	21 855	23 480	24 990	26 526	28 240	30 000
Structural Funds <sup>1</sup>	19 777	20 135	21 480	22 740	24 026	25 690	27 400
Cohesion Funds	1 500	1 750	2 000	2 250	2 500	2 550	2 600
3. Internal policies	3 940	4 084	4 323	4 520	4 710	4 910	5 100
4. External action <sup>2</sup>	3 950	4 000	4 280	4 560	4 830	5 180	5 600
5. Administrative expenditure	3 280	3 380	3 580	3 690	3 800	3 850	3 900
6. Reserves	1 500	1 500	1 100	1 100	1 100	1 100	1 100
Monetary reserve	1 000	1 000	500	500	500	500	500
External loan guarantees	300	300	300	300	300	300	300
Exceptional external expenditure	200	200	300	300	300	300	300
Total commitment appropriations	69 177	69 944	74 485	75 224	77 987	80 977	84 089
Payment appropriations required	65 908	67 036	69 150	71 290	74 491	77 249	80 114
As a % of GNP	1,20	1,19	1,20	1,21	1,23	1,25	1,26
Margin for revision as a % of GNP	0,00	0,01	0,01	0,01	0,01	0,01	0,01
Own resources ceiling as a % of GNP	1,20	1,20	1,21	1,22	1,24	1,26	1,27
<sup>1</sup> Objective 1 regions	12 328	13 220	14 300	15 330	16 396	17 820	19 280
<sup>2</sup> Total external expenditure including reserves	4 450	4 500	4 880	5 160	5 430	5 780	6 200

billion reserve was created to finance an insurance fund against the risk of third countries defaulting on debts guaranteed by the Community. Following the collapse of the communist regimes in Eastern Europe, the outstanding stock of such debts has been growing steadily. In April 1993, about 80% of committed loans or ECU 3,8 billion had been taken up.

While the increments in overall Community spending planned for the rest of the decade are all in all quite moderate,

especially in terms of Community GDP or, as shall be noted later, with respect to public outlays at national level, the Edinburgh decisions on the revenue side did not mark a substantial break with the past either. By reducing step-wise the call-up rate of the VAT resource from 1,4 to 1%, as well as the size of the uniform VAT base to maximum 50% instead of 55%, the relative importance of the fourth resource is bound to rise further from 1995 onward. The controversial UK rebate formula also was left unchanged.

## **Part B**

# **The challenge of EMU for EC public finance**



*The purpose of this part is to explore in depth the economics of the nexus between EMU and EC public finance. It occupies a central position in this report as it constitutes the analytical lynchpin for the operational propositions put forward in Part C.*

*This part comes in two chapters. First a concise review is offered of the theoretical framework in which this nexus should be discussed. The fiscal federalism literature points to various possible grounds for shifting policy competences from the national to supranational level, but at the same time it makes clear that any centralization is also likely to entail some drawbacks in terms of welfare such that the assignment of competences between levels of government should rest on a cost-benefit analysis. Economic federalism places the burden of the proof with those wishing to centralize, which accords fully with the subsidiarity paradigm that the Community has adopted as the guiding principle for the organization of its economic system. Besides providing the theoretical underpinnings, Chapter 3 also gives a concise, stylized account of the current distribution of spending and taxation powers in mature federations, which will also serve as a benchmark for the arguments developed in Part D.*

*Building on the insights from fiscal federalism and the extensive analysis that has been brought to bear recently on the economics of EMU, Chapter 4 will then address the key set of questions of the report. Despite its shortcomings, the familiar Musgravian division of public economic functions is used to get a handle on the different aspects of the consequences of EMU. The principal conclusions ensuing from the analysis can be summed up as follows:*

- (i) Solid economic arguments can be advanced to strengthen the Community's budgetary means to promote common policies in areas like environmental protection, infrastructure, and R&D. There also exists a powerful case for attributing more responsibilities and funds to the EC level of government with regard to aid to third countries. On the other hand, the conduct of new common sectoral policies ought not to lead to significant demands on EC budget expenditure. Greater Community involvement can be advocated concerning capital income taxes, corporate taxes, and some types of environmental taxes.*
- (ii) The Community budget will not be able to fulfil an EC-wide stabilization role. This should not pose a serious problem so long as the broad compatibility of the Community's aggregate fiscal stance with the single monetary policy is ensured by the coordination of Member States' budgetary policies. The loss of the national exchange-rate instrument calls for the deployment of an EC scheme to support regional adjustment. In federal and unitary countries this stabilization support is in large degree delivered automatically through the central tax and social security system. In addition to the fact that the Community budget is not sufficiently flexible and much too small to produce such effects, there are convincing microeconomic and managerial reasons to doubt the desirability of automatic stabilizers at EC level. Preference should go instead to a mutual insurance mechanism against country-specific shocks of macroeconomic significance.*
- (iii) Economic analysis does not shed conclusive light on the impact of EMU on regional disparities. Other things being equal, the move to EMU will therefore not necessarily have to be accompanied by a strong expansion of the cohesion budget. The Community has no role to play in interpersonal redistribution. In the pre-federal stage, unconditional interregional fiscal equalization flows are not to be recommended either.*



## Chapter 3

# Public finance in a system of multi-layer government

## 3.1. Fiscal federalism and subsidiarity

The economic principles involved in assigning different expenditure and tax/transfer functions to different levels of government are dealt with in a branch of public finance economics commonly called fiscal federalism. The modern literature originated in the late 1950s and came of age with Oates' classical work *Fiscal federalism* (1972), which formed an important source of inspiration for the MacDougall report. It is obviously beyond the scope of this report to discuss extensively developments since then and the interested reader is referred to Walsh (1993). However, it is fair to say that apart from a few notable exceptions in particular as regards income redistribution, the main messages of the literature have not changed significantly over the last 15 years. This is in part due to the fact that the theory of the second best, which has strongly permeated most other branches of the public finance literature, has not yet been applied systematically to the assignment of competences question.<sup>1</sup>

In a way, the fiscal federalism literature has now become more relevant to the discussion of EC issues than at the time of the MacDougall report because it presupposes the existence of an internal market and a single currency. Nevertheless, the lessons for the Community to be derived from it are bound to be limited, essentially on account of the fact that fiscal federalism theory has primarily been concerned with the provision of local public goods and thus with local versus national assignment questions, thereby putting strong emphasis on the allocation dimension of economic policy functions. However, as already argued in Forte (1977), the parallel between the national v. supranational and the local v. national dichotomy is defective with respect to a number of crucial economic policy domains, such as in defence, or stabilization or redistribution policy. As a result, some of the usual fiscal federalism policy prescriptions are inadvis-

able, or at least questionable, in the Community context.<sup>2</sup> This observation is corroborated by the finding that the literature is weak when it comes to recommendations about how federations ought to evolve through time.

### 3.1.1. Competence assignment criteria

The general maxim of economic theory is to favour as far as possible the decentralization of economic decisions and to leave them in private hands as it achieves the best match of individual preferences and the supply of goods and services. Governments should only step in to provide 'public' goods or incentives through taxes, subsidies or regulations, when private markets do not secure social efficiency or equity, and then only inasmuch as their actions do not create larger distortions than those they seek to rectify.

Lower levels of government are in principle better placed to fulfil such public functions than higher ones. Consequently, with a view to maximizing welfare of the Community as a whole, policy competences should normally remain vested with the national (or regional) instead of the Community level of government. The usual arguments invoked to support this view are:

- (i) Member States are more apt to offer a specific bundle of public goods and services tailored and financed according to the tastes and preferences of the national electorate. By virtue of smaller jurisdictions, public supplies can be differentiated, reducing the size of minorities that feel frustrated because their views have not been accounted for;
- (ii) people have typically better access to national governments and their administration than to the European decision-making bodies, making democratic control more effective and thereby diminishing the risk of government failure;<sup>3</sup>
- (iii) decentralized supply of public goods and services permits greater competition among jurisdictions and innovation, in particular when individuals, firms and capital

<sup>1</sup> This is rather paradoxical as the fundamental hypothesis of fiscal federalism theory is of a second-best nature, namely that central government is unable to provide regionally differentiated goods and services.

<sup>2</sup> In addition, the fiscal federalism literature typically assumes that some form of representative democratic government exists at all levels of decision-making. Due account of decision-making processes characterized by veto powers or 'democratic deficits' is liable to modify views on the appropriate distribution of competences.

<sup>3</sup> The arguments on preferences and democratic control reflect the notion that decentralized decision-making brings government closer to the people. This idea has been given a formal treatment in Tresch (1981).



exhibit a high degree of cross-border mobility.<sup>1</sup> The threat of 'voting with the feet' will exert pressure on national governments to deliver value for money. Moreover, national autonomy permits policy flexibility and scope for experiments, which, if successful, could be copied by other Member States.

Against the benefits of decentralization need to be set the potential costs in terms of efficiency and equity. The latter can be neutralized either by a voluntary coordination process between national authorities or by a transfer of competences to the supranational level. Failing voluntary coordination,<sup>2</sup> the fiscal federalism literature identifies three basic sets of circumstances in which the Community may be better placed than the Member States for the effective delivery of a policy. The first two are closely related to the pursuit of optimal welfare for the Community as a whole, the third is more of a politico-economic nature as it concerns equity.

The first is the existence of cross-border spill-over effects giving rise to so-called externalities: when domestic policies have a (positive or negative) impact on the economies of the other Member States which a national government ignores, these policies are bound to be suboptimal for the Community in its entirety. The more integrated national economies grow, the more prominent externalities will tend to become, with powerful spill-over mechanisms at play in all major fields of economic policy. As new channels of spill-overs emerge, the Community's task is to internalize externalities that evolve over time, which is tantamount to the statement that economic union is an open-ended concept.

The second circumstance pertains to all policy functions characterized by economies of scale or indivisibilities, al-

lowing for efficiency gains when the policy is performed at a higher level of government. In a similar vein, as the whole weighs more than the sum of the units, a Community approach may strengthen the EC's bargaining position *vis-à-vis* third countries, improving the chances of a favourable outcome of international negotiations.

The third rationale for competences at EC level concerns the pursuit of a certain level of homogeneity or fairness. This may be inspired by largely economic considerations — like the prevention of secession or congestion in affluent regions — or by more altruistic motives deriving from feelings of common citizenship. If it is deemed necessary that a certain (relative) level of purchasing power per capita be reached, or that all regions of Member States be given the opportunity in terms of structural endowments to compete fairly inside the Community, transfers need to be decided on and organized at the supranational level.

The distribution of powers between the Community and the Member States may often be clear-cut on the basis of the above assignment criteria. However, in quite a number of policy areas a fine trade-off between efficiency or homogeneity and the advantages of diversity is required. Given that European integration is a voluntary 'bottom-up' process involving sovereign countries that insist on keeping their powers as unfettered as possible, the benefit of the doubt in this regard should be granted to the national level. Cast in more political terminology, the principle of subsidiarity stipulating that a higher level of government should only assume responsibilities that cannot be taken care of effectively by a lower level of government, should be observed.

The subsidiarity principle, which is enshrined explicitly in the Maastricht Treaty on European Union (the new Article 3b) entails several important operational implications. For one thing, the transfer of competences to the Community should respect a degree of proportionality. It is only when independent national measures lead to significant externalities or are unable to harvest considerable efficiency gains that the EC should come into play. Put differently, in developing the distribution of economic powers to flank EMU, the Community ought not to lapse into systemic overshooting.

For another, as the ultimate purpose of a higher level of government is the increase in total welfare, EC involvement is only justifiable if the gains it generates from substituting for failures of coordination between Member States are not offset by high administrative or compliance costs, or by the possibly poor quality of the Community policy replacing previous national ones.

One channel to avert the latter set of problems is to devolve, as far as possible, the executive facets of the competences

<sup>1</sup> The role of mobility as an instrument for the revelation of preferences was highlighted first in Tiebout (1956). The advantages arising from competition among jurisdictions are stressed in the 'public choice' literature on public finance, as illustrated in Schneider (1993), or Brennan and Buchanan (1980). However, competition and mobility may also spawn undesired effects (see Section 4.1.2 and Part D).

<sup>2</sup> Voluntary coordination often proves elusive because the conditions for efficient bargaining are stringent. All parties should for instance have perfect knowledge about each other's preferences. For strategic reasons, bargainers may have an incentive to conceal their true preferences. In addition, some parties may be convinced that agreement may not be respected by all involved. It follows that the mere possibility of a mutually advantageous accord does not guarantee that such an agreement will be reached. The costs of coordination within a broader analytical framework featuring other sources of costs such as preference revelation and mobility are discussed in depth in Breton and Scott (1978). *Prima facie* their analysis suggests that, generally speaking, the degree of policy centralization in the Community is too low because supranational interests are underrepresented in the main decision-making body and the EC's access to financial resources is strictly circumscribed. See Walsh (1993).

assigned to the Community level to national or regional administrations, or even to private sector bodies. A high degree of decentralization of implementation of EC measures would be in keeping with the modern 'cooperative federalism' practice in most federations and with a precept of public management that those responsible for executing measures be close to the private agents for whom they are destined.<sup>1</sup> It would at the same time remove the need for a considerable expansion of the 'federal' administration.

In a number of policy areas, the Community has already pursued this line of conduct,<sup>2</sup> albeit with mixed results as can be inferred from the volume of fraud the revenue and in particular the expenditure side of the budget are presumed to suffer from. As will be argued in Chapter 10, for the efficiency advantages from executive devolution to be reaped, it is essential that more thought be given to the unavoidable principal/agent problem with administrative decentralization.

### 3.1.2. The use of 'federal' public finance instruments

The foregoing assignment criteria and executive devolution principle can be applied as a general rule to all economic policy instruments that any government can theoretically avail itself of, i.e. regulation, spending, taxation (including charges) and borrowing.

<sup>1</sup> Cooperative federalism typically helps to reduce preference revelation costs but may create new problems, including the perverse effects of grants, or decision-making traps. See Scharpf (1988).

<sup>2</sup> Examples are the collection of the Community's own resources, the detailed execution of the common trade and agricultural policies, the writing and updating of technical product requirements by standardization bodies like CEN and Cenelec.

This subsection looks at how the use of these instruments should be conceived within the specific context of multi-layer government. Given this report's remit, it will leave aside purely regulatory intervention, it being understood, however, that hitherto, regulation has been the Community's prime means of action, as exemplified by the wide-ranging internal market completion programme.

It is convenient to discuss these matters with the help of an illustrative matrix classification of EC economic policy instruments and intervention purposes, as presented in Table 5.

The public finance instruments at the disposal of the EC are indicated column-wise; the rows refer to the familiar Musgravian goals of economic policy: allocation (the efficient allocation of resources); stabilization (securing macroeconomic stability, i.e. minimizing the deviation of actual from potential output); redistribution (the correction of primary income differentials for the sake of equity). Ignoring the first column, each broad category of public finance instrument can be further split into two components on account of the 'vertical' structure of the Community. The first pertains to direct budgetary action by the EC, the second relates to a more indirect incidence, through the operation of intergovernmental financial flows and EC rules on taxation, which influence Member States' public finance behaviour.

Besides outlays for the direct purchase of goods and services, expenditure by the central level of government takes the form of grants to subcentral authorities. As reviewed in Walsh (1993), Spahn (1993a) and Costello (1993a), there exist different types of grants (specific/general, lump-sum/matching, open/closed), which can serve a variety of both allocation and redistribution purposes. Specific-purpose grants of a matching nature are typically deployed for the correction of cross-border externalities, or to promote the

**Table 5**

**EC economic policy instruments/intervention areas matrix**

Intervention areas	Instruments					
	Regulation (token entry)	Expenditure		Revenue		Borrowing
		on direct provision of public services	Grants to lower level of government	Own resources	Common rules on taxation	For own use For on-lending
Allocation						
Stabilization						
Redistribution						

economic potential of lagging regions, for they are meant to restrict grantees' spending behaviour.<sup>1</sup> On the other hand, general purpose grants, which are essentially unconditional, seek either to eliminate 'vertical imbalance' in access to revenue sources and/or to achieve interregional redistribution through transfers on the basis of regional differences in fiscal capacity or public service needs. At present, the Community's grants to Member State governments are exclusively of the specific purpose kind in the framework of the Structural Funds. An important question in the redistributive field to be addressed in Chapters 4 and 5 is whether or not the EC's regional transfers should be expanded to include general purpose grants as well.

As regards revenue, it is important to distinguish between on the one hand, the centralization of the proceeds from taxes for the coverage of EC expenditure, i.e. the size and composition of Community 'own resources', and on the other, the centralization at EC level of tax legislation, i.e. the harmonization of or the adoption of minimum rules on national tax regimes for the sake of preventing beggar-thy-neighbour tax competition with respect to tax bases displaying a high degree of cross-border mobility.

Own resources can in principle be obtained in two sorts of ways: through taxes proper, on economic agents' incomes or transactions, or via 'intergovernmental' means of unconditional block grants from every Member State, which may reflect the latter's relative prosperity levels in a fiscally neutral or progressive fashion.

Basically four types of taxes can be distinguished within the framework of multi-layer government, depending on the vertical distribution of tax competences and/or revenue. Ranking them in descending order of autonomy for the level of government concerned, these four types are:

- (i) exclusive taxes: the competent level of government enjoys full autonomy over all aspects over the tax in question. Customs duties form a current example for the Community;
- (ii) competing taxes: two different layers of government collect independently of each other a tax on the same transaction or source of income, resulting in an uncoordinated overlap of fiscal competences. While exhibiting the advantage of allowing for a high degree of fiscal freedom, competing taxes may give rise to a tax jungle, with serious administrative and compliance costs;

- (iii) subfederal surcharges (tax base sharing): under this regime, states introduce a supplementary levy on the tax imposed by the federal government (or vice-versa). Surcharges ensure that the definition of the tax base is uniform, the subfederal competence being confined to fixing its surcharge, resulting in regionally differentiated rates;<sup>2</sup>

- (iv) shared taxes (tax revenue sharing): under this arrangement, the tax base and rates are identical in the entire union. The proceeds, levied and possibly collected by the central level, are shared vertically with the Member States according to predetermined distribution keys. The key relative to the horizontal distribution among Member States may be based on a pure territoriality principle, but by biasing it to the benefit of the least prosperous it may also serve as an instrument of interregional redistribution. This bias could also operate by means of country-specific keys in the vertical sharing, or for that matter in the set-up of a surcharge regime, as has been suggested in the past to remedy the regressive properties of the Community's VAT receipts.

In Chapter 7 we examine in detail which taxes should be assigned to the Community for own resource purposes and of what type they should be, on the basis of the fiscal federalism principles set out here. However, at this stage of general discussion, and in line with federal practice reviewed presently, it may already be remarked that because the case for having EC rules on taxation proves easier to make than the case for centralizing expenditure competences, it is not hard from the viewpoint of economic analysis to identify suitable candidates for EC revenue to cover supranational spending. As will be explained in Section 4.1.2, the former case rests chiefly on the existence of negative cross-border externalities when Member States remain fully autonomous with respect to the taxation of internationally mobile bases, imparting a downward bias to fiscal pressure and inducing locational distortions during the tax competition process. The obvious way to internalize this externality is through common tax rules, which can take the form of a minimum or uniform tax across the Community, the proceeds from which may then be assigned wholly (exclusive taxes) or partly (surcharges or shared taxes) to the supranational budget.

Engaging in EC borrowing for own use at the supranational level is ruled out by the Treaty prohibition on Community

<sup>1</sup> The 'additionality' issue of the influence of specific-purpose grants on grantees' spending behaviour is addressed in Section 5.2.3.

<sup>2</sup> Contrary to what is sometimes stated, the Community's current VAT resource does not correspond to the surcharge regime since it is collected on a notional harmonized base, rather than as a supplement to the VAT paid on individual purchases to the national fisc. The link with actual VAT disappears totally in the case of seven Member States where the notional base has been capped at a predetermined level of GDP. See Section 7.1.1.

budget deficits. By contrast, since the onset of the Coal and Steel Community in 1951, a substantial volume of loans has been mobilized for on-lending. As explained in Kuhlmann (1993), the usefulness of the latter financial tool is rooted in the fact that by virtue of either the superior credit rating of the initial borrower on capital markets, or the provision of a guarantee or of interest subsidies, the effective cost for the eventual loan recipient is lowered. Abstracting from interest subsidies which are basically equivalent to conditional grants, the loan instrument can in principle be employed to pursue goals relating to all three domains of public intervention. But for this to be warranted economically, the existence of financial market imperfections, causing undue credit rationing, biased risk assessment or insufficiently long maturities, needs to be demonstrated. The EC's loan operations are conducted chiefly by the European Investment Bank whose interventions within the Community concentrate on the co-financing of infrastructure in lagging regions, or of large-scale investment projects of interest to more than one Member State. However, the loan instrument has in the past also been drawn on for stabilization purposes, as exemplified by the loans to Italy and Ireland at the launching of the EMS, the so-called New Community Instrument to help stimulate economic recovery at the turn of the 1980s, and the balance of payment loans of which the most recent one was extended to Greece in 1991. The main query to be addressed in Chapter 9 of this report is what will remain in EMU of the role of supranational borrowing for on-lending.

### 3.2. The distribution of public finance competences in mature federations

In the period before EMU will have reached its steady state, the Community will remain firmly in the pre-federal stage of integration, lacking the full social and political union dimension characterizing federal and *a fortiori* unitary States. As it cannot therefore be taken as a direct benchmark, current federal practice will not be reviewed in this section at great length, the more so as the role of central public finance in terms of the usual allocation, stabilization and redistribution objectives will be touched on in the next chapter. However, a look at the broad distribution of public finance powers in a number of mature federations (Australia, Canada, Germany, Switzerland and the USA) permits one to distil several stylized facts of a systemic nature about public finance in EMU. They should not be elevated to the status of 'iron laws' but they provide a useful perspective for the elaboration of the Community's future budgetary regime.

#### (i) *EMUs can function with widely varying degrees of expenditure centralization*

This degree can be read from column (3) of Table 6 which relates consolidated central government expenditure, net of grants to lower levels of government, to the sum of total government spending. It ranges from 42 to 61%, amounting to a variation of more than 45%. The width of this range demonstrates that there is seemingly a very wide spectrum of possibilities for central public finance in EMU. Moreover, the influence of central government on economic policy can be gauged only in part from relative spending levels. Influence can also be exerted by means of framework legislation, which provides for the centralized setting of guidelines whose application, with its budgetary implications, are a matter for subcentral authorities.

A functional breakdown of net consolidated central government outlays demonstrates that the latter consists to an overwhelming extent — typically about three quarters — of spending on defence and public order, social security and welfare, and interest payments on the national debt. It was assumed in Chapter 1 that the EC will not be allotted any significant budgetary role in the first two fields and by virtue of the prohibition on its incurring deficits, the Community does not have to service debt either. Deducting these budgetary items, column (6) shows that federal government spending drops to levels that are no longer completely different from the current size of 1.2% of the EC budget, in particular in the case of the USA, Canada and Switzerland, which were built up as confederations of highly autonomous states.

#### (ii) *Tax competences are typically more centralized than expenditure competences*

Except in the United States, where the two bases yielding close to 90% of federal fiscal revenue, personal and corporate income, are utilized 'competitively' by both the federal and state levels of government, the central authorities have a relatively bigger say on taxation than on spending, as can be inferred from Table 7. The two measures presented in columns (2) and (3) of the degree of centralization of revenue competences exceed in four out of the five federations that regarding spending powers. The most salient case is provided by Germany where on the second measure tax centralization is almost complete, with virtually all fiscal revenue of the *Länder* arising from shared taxes.

This more pronounced centralization of tax competences enables the deployment of vertically organized interregional equalization mechanisms through tax sharing arrangements and general purpose grants.

**Table 6****The centralization of expenditure competences in mature federations**

		(1)	(2)	(3)	(4)	(5)	(6)
Australia	(1988)	19,5	36,8	0,53	17	0,53	6,8
Canada	(1988)	19,0	45,4	0,42	22	0,46	4,8
Germany	(1987)	28,7	47,4	0,61	13	0,69	9,4
Switzerland	(1984)	18,5	38,1	0,48	13	0,58	4,6
USA	(1988)	21,5	36,4	0,59	9	0,70	5,7

(1) Consolidated central government expenditure net of general purpose grants to lower levels of government, as a percentage of GDP.

(2) Total government spending as a percentage of GDP.

(3) (1) divided by (2).

(4) State spending as a percentage of GDP.

(5) (1) divided by ((1) + (4)).

(6) Consolidated central government expenditure net of general purpose grants to state governments, social security and welfare outlays, defence and public order and interest payments on the national debt, as a percentage of GDP.

Source: IMF, government finance statistics.

**Table 7****Degree of expenditure and tax competence centralization**

		(1)	(2)	(3)
Australia	(1988)	0,53	84	84
Canada	(1988)	0,46	55	65
Germany	(1987)	0,69	76	98,4
Switzerland	(1984)	0,58	73	75,4
USA	(1988)	0,70	78	30

(1) Column (5) of Table 6.

(2) Tax revenue and social security contributions to consolidated central government relative to total tax and social security revenue of consolidated governments (in percentages).

(3) Exclusive federal taxes and social security contributions plus proceeds of shared taxes and surcharges relative to total tax and social security revenue of central and state governments.

*(iii) There is an inverse relationship between State public finance autonomy and interregional redistribution*

Public finance autonomy should be understood as relating to revenue sources, policy competences and the associated volume of expenditure and the degree of independence with respect to borrowing and levels of budget deficits, whilst interregional redistribution pertains to explicit grants as well as the regional incidence of federal taxes and expenditure and of the social security system. This inverse relationship was well-documented in Section 6.7 of the Commission's 'One market, one money' report, so there is no need here to demonstrate it once more. For the sake of convenience, the main summarizing table is reproduced below (Table 8).

Whereas this inverse relationship results, in part mechanically, from the fact that the capacity for interregional redistribution depends *ceteris paribus* on the size of the federal budget relative to the state budgets, it also stems from the need to ensure an adequate number of policy instruments for economic adjustment.<sup>1</sup> A State within EMU is faced with strongly restricted room for manoeuvre: monetary union rules out devaluation and may circumscribe States' capacity to borrow; also, economic union requirements often impose microeconomic constraints on public spending (as regards

<sup>1</sup> In some federations, such as the Canadian one, causality has proved to run also in the other direction: the increasing degree of interregional redistribution is often seen as having allowed for more room for manoeuvre in the conduct of provincial budgetary policies.

State aids, public procurement, and so forth), taxation, and labour market regulation. Interregional transfers may be needed to make up for the loss of national instruments lest the overall economic system become overdetermined. As a corollary, the more States' ability to spend, tax and borrow is restricted by the rules of EMU, the stronger becomes the case for the deployment of interregional insurance mechanisms against adverse economic events.

*(iv) Federal public finance enables substantial interregional income redistribution and contributes significantly to regional stabilization*

Both these functions of federal public finance materialize largely on an automatic basis on account of the prominence of the highest level of government in direct taxation and the operation of the social security system. As a consequence, they are strongly interrelated in practice, notwithstanding the clear conceptual difference between redistribution and stabilization.<sup>1</sup>

<sup>1</sup> Whereas interregional redistribution pertains to the level of federal expenditure and taxes that are a function of the level of a region's real income, stabilization concerns the variations in fiscal expenditure and taxes as a function of the rate of change of economic activity.

Empirical estimates, reported in Table 9, suggest that primary income disparities between states in a federation are typically reduced by 30 to 40% as a result of the fiscal activities of central governments. On the other hand, around 20 to 30% of a change in real economic activity in an individual state tends to be offset through federal financial flows.

**Table 8**

**Fiscal autonomy and fiscal equalization in existing federations**

	Ranking of fiscal autonomy	Ranking of interregional income equalization
Switzerland	1	5
USA	3	4
Canada	2	3
Germany	4	2
Australia	5	1

NB: '1' relates to highest, '5' to lowest.

Fiscal autonomy is defined here as consisting of three aspects: revenue sources, expenditure competences and the degree of independence with respect to borrowing and the level of the deficit. Autonomy of revenue sources was evaluated by looking at the percentage of exclusive and competing taxes and non-fiscal income in total regional revenue. The degree of expenditure competence was assessed on the basis of the share of state and local spending in total government (excluding social security). These three criteria together permit a rather clear ranking of fiscal autonomy.

The data on interregional income equalization are derived from the MacDougall report and refer to the average of individual regions' reductions in per capita personal income differences.

Source: Commission (1990).

**Table 9**

**Estimates of the degree of interregional income redistribution and regional stabilization in selected federal and unitary countries through central public finance channels**

	Interregional redistribution		Regional stabilization	
USA	35 to 44%	(Sachs and Sala-I-Martin, 1990)	10%	(Von Hagen, 1991) <sup>1</sup>
	25%	(MacDougall, 1977)	28%	(Bayoumi and Masson, 1991)
			20%	(Goodhart and Smith, 1993)
			17%	(Pisani-Ferry et al., 1993)
Canada	30%	(MacDougall)	17%	(Bayoumi and Masson)
			24%	(Goodhart and Smith)
Germany	35%	(MacDougall)	33 to 42%	(Pisani-Ferry et. al.)
Australia	50%	(MacDougall)	—	
Switzerland	15% <sup>2</sup>	(MacDougall)	—	
France	53%	(MacDougall)	37%	(Pisani-Ferry)
UK	34%	(MacDougall)	34%	(Goodhart and Smith)

NB: Interregional redistribution as defined under Table 10. Regional stabilization is the extent to which regional disposable income is *not* influenced by changes in local real economic activity, i.e., if changes in real activity would not affect regional income at all, stabilization would be at 100 %. See Pisani-Ferry et al., Chapter 2.

<sup>1</sup> Tax side only.

<sup>2</sup> Incomplete data.



- (v) *Explicit grants have stronger interregional equalization power than the ordinary federal budget and social security system*

Interpersonal redistribution, operating through progressive direct income taxes and the social security and welfare system, typically has a clear interregional incidence. Consequently, interpersonal redistribution schemes are partly substitutable for explicit interregional flows. However, the MacDougall report, which provided much original evidence on the interregional redistribution properties of public finance in federations, found that explicit grants (or tax sharing arrangements) displayed markedly more redistributive power than the nation-wide direct tax and income support mechanisms (see Table 10).<sup>1</sup> Grants achieve relatively large redistributive effects with relatively small amounts of federal expenditure, because the net interregional transfers are, less

than elsewhere, the result of differences between large payments in opposite directions.<sup>1</sup>

**Table 10**

**The redistributive impact of federal public finance**

	% redistributive power	% of GDP
Federal taxation and social security receipts	4	15,0
Federal direct public expenditure (defence, social security, etc.)	12	14,5
Specific purpose grants from the federation to the states	7	2,5
General purpose grants from the federation to the states	12	1,2
Total	35	—

NB: Based on data for Germany, Australia, Canada, Switzerland, and the USA in the early 1970s. 'Redistributive power' is defined as the (percentage) degree to which inter-state per capita income differences are equalized as a result of inter-state flows of public finance. The '% of GDP' figures indicate the amount of expenditure for each category, for the unweighted average of the five federations.

Source: MacDougall report (1977).

<sup>1</sup> Redistributive power relates to the extent to which regional primary income differentials are reduced. It was computed in the MacDougall report as the percentage change of the modified income differential relative to the primary income differential. In other words, if a rich region is at 120% of national primary income per capita, and after taxes and transfers its income has dropped to 115% of the national average, the redistributive power of taxes and transfers amounts to 25%.

<sup>2</sup> MacDougall report, Volume I, p. 13.

## Chapter 4

### EMU and EC public finance: the central economic issues

This chapter addresses the question whether supplementary economic competences having a public finance incidence — be it in terms of expenditure, taxation or borrowing and lending — need to be assigned to the Community level of government for the sake of the proper functioning of the economic and monetary union.

The discussion will again be organized according to the familiar Musgravian division of economic policy functions into the three dimensions of allocation, stabilization and redistribution. This choice of framework is more inspired by considerations of convenience than analytical rigour. Most notably, it has become increasingly recognized in the recent literature on public finance that if account is taken of the fact that taxes and transfers can themselves be serious sources of distortion and that therefore the income distribution effects of public policies cannot be offset without a welfare loss, a clear separation of these three domains, and in particular between allocation and redistribution, is hard to uphold.<sup>1</sup>

It should also be remembered that there is no neat correspondence between the functional distribution (defence, education, public health, etc.) of public spending or the types of government revenue and the Musgravian categories of intervention. For instance, a rise in excises may, besides influencing the consumption of specific goods (allocation) have a differentiated impact on households' purchasing power (distribution) and, depending on the use of the increase in tax proceeds and the economy's cyclical position, exert a (de)stabilizing effect. This remark holds in particular for stabilization policy as there is basically no expenditure or revenue item that is earmarked for exclusive stabilization purposes. Budgetary interventions often have important stabilization properties, usually as a side-effect. It will also be evident in Chapter 5 that much EC expenditure that forms part of allocation policies is undertaken in the pursuit of interregional distribution objectives.

This chapter will, of course, draw on the various strands of analysis that have been brought to bear on the economics of EMU. The recent past has seen a rapid burgeoning of the

literature, but growth has been uneven: monetary union has so far received much more attention than economic union, and, due to the fact that international monetary economics forms part of the macroeconomic discipline, the stabilization issue has been privileged within the monetary tier. This situation is also mirrored in this chapter, where the new analytical insights that will be brought to bear on the economics of the EC budget will be relatively richest in the part on stabilization.

#### 4.1. Economic union and allocation policy

Economic union was defined earlier as a single market (characterized by the free movement of goods, services, capital and persons, and the absence of economic discrimination on the basis of nationality) flanked by a 'positive integration' set of common policies and rules designed to exploit its full welfare potential.<sup>2</sup> In the allocative domain, these common policies and rules could be seen as the visible hand operating across borders to optimize the use of resources in the Community as a whole.

Given the Community's fundamentally market-oriented economic order (a precept that has been explicitly confirmed in Article 3a of the Maastricht Treaty on European Union), the question relative to Community involvement in the promotion of economic efficiency is twofold:

- (i) the identification of circumstances where public intervention is likely to offer welfare increments over private markets, in the knowledge that public intervention is typically costly and distortionary in its own right;
- (ii) the identification of cases where significant benefits accrue that could not be attained by leaving the policy responsibility with the Member States.

The public finance aspects of the nexus between economic union and allocation policy thus present themselves in two parts. First, what Community microeconomic policies entailing outlays or borrowing for on-lending need to be strengthened or deployed to flank the completed internal

<sup>1</sup> This forms one explanation of why sectoral or commercial policies are in practice designed to pursue a mixture of allocation and income distribution goals.

<sup>2</sup> Although it is useful for the sake of analytical clarity to distinguish between an internal market and economic union, as is done in textbooks on the theory of economic integration where economic union is seen as a 'higher' stage, the Community's actual integration pattern has not strictly conformed to this distinction, with the provisions enabling the establishment of competition policy, legislative harmonization pursuant to Article 100 EEC, and a common agricultural and transport policy already in the founding Treaty. The Single European Act constituted another milestone by widening Community competences to areas like R&D and the environment. Many of the building blocks for the accompanying policies have thus already been put in place.



market and monetary union? Second, what areas of taxation should be made subject to Community rules towards uniformity, approximation, or minimum levels in order to avert the occurrence of a 'beggar thy neighbour' tax competition process, harming economic efficiency *inter alia* by provoking locational distortions?

#### 4.1.1. Stepping up the budgetary means for 'positive integration'

As they constitute a positive externality, public goods and services delivered below cost tend to be undersupplied when they spill-over into other jurisdictions. In principle, when there are only a few Member States concerned and the magnitude and flow of benefits are clear, the externality may be internalized smoothly by voluntary coordination. However, efficient bargaining becomes elusive when the number of countries involved goes up and stakes are complex. This forms the classical case for the assignment of the policy responsibility at Community level, at least as far as the spill-over dimension of the competence is concerned. The other main motivation resides in the presence of economies of scale or indivisibilities of such a nature that the execution of the function at the level of national governments is impossible or inefficient.

As argued in Costello (1993b), circumstances corresponding to either of these motivations may occur regularly as regards the provision of public goods and services in fields like:

- (i) environmental protection;
- (ii) road, rail, telecommunications infrastructure and common energy carriers;
- (iii) research and development;
- (iv) and, to a lesser extent, higher education.

In what follows the economic rationale for Community spending in these areas is developed in some further depth. Attendant budgetary magnitudes will be roughly quantified in Section 5.1.

The chief objective of environmental policy is how to ensure the appropriate use of scarce but vital resources — like clean air and water — that nobody owns. The absence of property rights to environmental goods gives rise to market failures requiring government intervention. Once polluting activities produce effects across borders, international cooperation is in order since otherwise countries will be tempted not to bear their fair share of the burden, leading to an insufficient degree of policy stringency. The main instruments of environmental policy are regulation and taxation (see Section

4.1.2), measures which need to be undertaken in a Community framework since technical and fiscal barriers to trade incompatible with the internal market may otherwise arise. Environmental policy also displays a public expenditure dimension, for which the Community level of government may be better placed to undertake than the Member States. The rapidly growing awareness of the environmental problem has highlighted the deficiencies in scientific knowledge, statistical information, technology and product and process standards. The urgency and scale of the task suggest substantial economies can be obtained through common efforts, in which the planned European Environmental Agency should play a central role. Community spending may also be required where EC legislation imposes binding environmental standards, the respect of which may place a considerable financial burden on lagging Member States.

The provision of infrastructure has traditionally been in the public purview and motivated by the existence of natural monopoly conditions, network externalities and the pursuit of regional or social goals. However, renewed emphasis on the virtues of the market mechanism, along with technological developments enabling a reduction in the relative importance of sunk costs and facilitating the collection of fees from infrastructure users has led over the last 10 to 15 years to a general questioning of this quasi-exclusive public role. Public v. private provision of infrastructure has increasingly become an empirical matter, centring largely on the ease of collection of charges and monitoring by supervisory bodies of private suppliers' pricing behaviour. The EC's role in infrastructure provision is to coordinate network design ensuring that system economies are exploited, to prevent unnecessary technical incompatibilities from arising, especially in new technology fields, and to ensure the proper functioning of the internal market by guaranteeing sufficient cross-border linkages. While largely having a coordination and regulatory role, some EC finance (grants and loans) is required, especially if the allocation role of infrastructure is combined with interregional redistributive objectives of the Structural Funds and the Cohesion Fund.

Public support to research and development is warranted whenever the fruits of R&D are not entirely appropriable by the private investor. This is generally the case as far as basic research is concerned, the results of which cannot be translated directly into product or process innovation. Government intervention usually takes the form of either grants or the provision of intellectual property rights. Financial aid to more downstream projects is harder to argue for but may be justified especially when the prohibitive financial requirements of high-tech R&D generates strategic industrial and trade policy considerations. Community spending on R&D should desirably complement national undertakings with a strong EC dimension, i.e. where a common effort,

apart from avoiding duplication, permits exploitation of synergies, reaps economies of scale and takes account of international spill-overs. Areas where these conditions are seen to apply include industrial production and technology, energy (including nuclear), and infrastructure planning and general land use.

Higher education in the EC is overwhelmingly financed by public means. Besides equity concerns, this is usually motivated by the argument that the availability of expert skills and knowledge benefits the whole of the economy. As these benefits are likely in the foreseeable future to remain chiefly within national borders, no major case can be made for a strong budgetary EC involvement. Supranational support should come mainly through scholarships for covering the extra cost of stays abroad. Although they clearly serve a political objective as well, such scholarships can be defended on economic grounds as they contribute to overcoming the cultural barriers in the internal market.

As to the future of sectoral policies and their incidence on the EC budget, the principal issue, given its 58% share in total outlays, is the long-term development of expenditure associated with the common agricultural policy.

This development is surrounded by a strong degree of uncertainty as it will depend on the implementation and the future course of CAP reform, which will be related to the eventual outcome of the Uruguay Round negotiations and the evolution of EC agricultural trade policy *vis-à-vis* Eastern Europe. The CAP reform measures of May 1992 form a substantial step in the direction of desirable reform, the fundamental aim of which should be to separate the allocation and redistribution aspects of current agricultural policy. The CAP needs to be reoriented to offer direct income support — which may be supplemented by national income transfers to farmers — subject to the fulfilment by beneficiaries of 'public' tasks, such as environment management.

However, it seems plausible that in the short to medium term, with the probable commitment by the EC to reduce its external protection, the explicit financial support to the agricultural sector will not fall in real terms. In the medium to longer term, and provided that intervention is altered to take the form of direct income support, real CAP spending is likely to decline gradually as more than half of the Community's farmers are over 50 years old.

Agriculture and, to a much lesser extent, coal and steel, form the only cases of a Community sectoral policy with a strong incidence on the EC budget. The way in which they were established during the Community's initial phase was heavily

influenced by political factors against the backdrop of the wartime memories of food shortages and the 1951 Schuman Declaration. Irrespective of the question of their usefulness, the pursuit of other common sectoral policies, be they in favour of declining or infant industries, ought not on a dual account to lead to sizable spending at EC level. For one thing, Member States may have very divergent preferences as regards both the sector to help and the means to achieve it — thus provoking the 'frustration' costs alluded to in Section 3.1.1. For another, the disbursement of aid at EC level may give rise to fiscal illusion on the part of Member States as national electorates are not well-informed about the level of budgetary support, thereby impairing democratic control and hence the resistance to sectoral lobbies. If direct intervention to bolster the competitiveness of European industry were felt necessary, it would seem advisable instead to design a sector-specific EC framework for national State aids, possibly, as a last resort, in combination with external trade measures.

Finally, a large question mark hangs over the future Community role outside the commercial and monetary field *vis-à-vis* third countries. Although unrelated to the completion of EMU, this issue cannot be avoided altogether in the present report since, as will become clear in Chapter 5, changes in this role are liable to have a significant budgetary influence. Given the assumption formulated in Chapter 1 that the Community will not be given any expenditure-intensive defence responsibilities in the period under consideration, the discussion is confined here to the assignment of competences between the Community and the Member States in relation to aid to third countries.

A greater Community role can be advocated on several grounds. To start with, development assistance often brings advantages to donor countries which spill over to rich neighbours. For example, if aid by one Member State helps to stem a potential migratory wave from Eastern Europe or North Africa to the EC, other Member States benefit as well. Much like defence expenditure in an alliance, aid to third countries exhibits positive externality features, causing the volume of development assistance by Community countries to be too low for their own good. A common policy can serve to rectify this downward bias.

Additionally, a common attitude will strengthen the Twelve's bargaining position *vis-à-vis* recipient nations, especially in cases where aid is subject to broad conditions, like the respect of human rights, market reform, or the preservation of environmental goods with a global value. If non-compliance is seen to prompt a halt of transfers from the whole of the Community, recipient countries will undoubtedly be more amenable than otherwise to fulfil their part of the contract.

Conversely, a common development policy offers more flexibility to beneficiary countries in the execution of projects. Recipients are often obliged to use the financial assistance for purchases of goods or services in the donor country. Inasmuch as such tying-in practices are at all defensible, the replacement of national preferences by a single Community preference will leave developing countries with a much wider choice and ensure them better value for money by virtue of the keener competition between potential suppliers.<sup>1</sup>

In these ways, a shift of competences to the EC level of government should lead to a development aid policy that is superior to the present one in terms of both quantity and quality. At the same time it should be recognized, however, that the disappearance of a disguised national export subsidy instrument may make Member States rather reluctant to accept greater Community involvement.

#### 4.1.2. Widening the *acquis communautaire* on taxation

The completion of the internal market and the establishment of a single currency will elicit a much closer integration of goods' and services' markets as well as enhanced cross-border mobility of asset holders, enterprises, workers and shoppers. If countries are convinced that unilateral tax cuts can secure them an economic advantage by providing local producers with a competitive edge and out-of-country capital income earners and consumers with a fiscal incentive to carry out their business locally, the possibility looms that, in the absence of coordination or supranational measures, a mutual outbidding 'tax competition' may be triggered.<sup>2</sup>

Already back in the 1970s, Member States harmonized their indirect tax base in a bid to reconcile the abolition of border controls with the maintenance of the destination principle (for VAT-liable economic agents). To keep cross-border shopping within reasonable limits, in June 1991 an agreement fixing minimum rates for VAT and excise duties was reached. This section addresses briefly in what other areas of taxation common (minimum) rules may be called for.

#### *Adverse consequences of unrestrained tax competition*

Although one ought not to overlook the important micro- as well as macroeconomic advantages deriving from tax

diversity and tax autonomy, it is obvious that an unbridled tax competition process may yield a number of harmful consequences for the efficiency of the Community economy as a whole. If competition is left to run its course, Member States will set tax rates at a lower level than they would if acting cooperatively because they neglect the negative externality of their lower tax rates on the revenue of their neighbours.<sup>3</sup>

This tendency would occur most inconveniently at the outset of the transitional phase to EMU, as it erodes the tax intake at a time when several Member States need to undertake great efforts to redress their public finance imbalances and put their excessive debt-to-GDP ratio on a downward path toward what is deemed acceptable for access to the final phase of EMU.

In addition, significant differences in effective tax rates may provoke locational distortions, in the sense of prompting decisions on where in the Community to produce, invest or collect capital income that would not be made in the absence of taxes. Such distortions misdirect resource allocation and thereby weaken the Community's economic efficiency. Finally, distribution problems may emerge among countries of the tax proceeds from firms or individuals operating in more than one Member State. The absence of common rules is likely to foster free-riding behaviour with firms (through abusive transfer pricing or thin capitalization practices) or individuals in border areas (through the judicious choice of fiscal residence) consuming public goods and services at prices below marginal cost in countries A and B but paying direct taxes only in country B.

#### *Base mobility and the scope for tax competition*

Clearly, the risk of beggar-thy-neighbour fiscal competition and hence the need for common rules to constrain it is not identical for all tax categories. It grows with the international mobility of the tax base.

The most mobile base is beyond doubt income from financial assets, which can be shifted rapidly from one jurisdiction to another with virtually no transaction costs. As a result of the current distinction in fiscal treatment between residents and non-residents and/or due to bank secrecy laws, the ongoing competitive process threatens to degenerate into a situation where each country acts as a tax haven for financial asset holders residing in the 11 other Member States. Given the extreme mobility of capital, a satisfactory solution may even require a worldwide agreement to this effect.

<sup>1</sup> This argument is elaborated in Jepma, Jansen and Kamphuis (1992).

<sup>2</sup> In the discussions on tax competition in the EC it is generally assumed implicitly that substitution effects prevail over income effects, i.e. that the spill-over bears a negative sign. Recent analytical work on the USA as reported in Eichengreen (1990) suggests, however, that this central hypothesis does not always hold.

<sup>3</sup> Some economists, notably the adherents to the public choice school of thought, would not consider this an undesirable phenomenon, as it keeps the national Leviathans in check. They would argue that tax coordination amounts to setting up a disguised fiscal cartel.

Although little is known as yet with certainty about the importance in the EC of corporate taxes in the location decision of firms, it is probable that under the impetus of deepening economic integration enterprises will grow increasingly mobile and multinational. This may over time also necessitate binding rules at EC level, in particular on the fiscal treatment of transnational profit flows between units of multinational firms.

In several OECD countries, including some Member States, environmental taxes form the newest addition to the arsenal of fiscal instruments, or are about to be introduced. If pollution displays the characteristic of spilling over across borders and an environmental tax is deployed to combat it, it is to be expected that if Member States were to decide on the matter in a non-cooperative fashion, national rates would fall short of what would normally be deemed the optimal level (Spahn (1993b)). Especially in cases where the direction of international flows of pollution is hard to ascertain with a high degree of precision — as with carbon emissions — there are strong grounds for empowering the supranational government to harmonize the taxable base and set minimum rates, or impose an altogether uniform tax if it were considered that providing a polluter with a different incentive to abate depending on his nationality were at variance with the notion of fair competition in the internal market.

In contrast, the scope for serious cross-border externalities is minor in the case of taxes on labour income and social security contributions since international mobility is likely to remain limited, for a long time to come, to very small segments of the labour market. By definition, the real-estate tax base cannot move to other jurisdictions at all.<sup>1</sup>

From the foregoing considerations it is evident that serious economic efficiency reasons can be advanced in favour of a greater Community involvement regarding capital income taxes, corporate taxes, and some types of environmental taxes. Carrying the argument one step further, any one of them could, in principle, be a convenient source of supranational revenue. It is, however, in this context important to stress that economic efficiency is one, but by no means the sole, factor to be taken into account when assessing the relative merits of different types of taxes and of general purpose grants from the Member States as EC own resources (see Spahn (1993a)). A host of other elements needs to be reckoned with, as will be done in Chapter 7, where concrete recommendations on the future of own resources will be formulated.

<sup>1</sup> This does not imply, however, that property taxes do not have any direct or indirect incidence on production costs.

## 4.2. Monetary union and stabilization aspects

Macroeconomic stabilization policy refers to any intervention by the government to minimize deviations of actual output from potential, full-employment output. It finds its motivation in the belief<sup>2</sup> that on account of institutional rigidities and/or expectational errors, prices, and especially that of labour, take time to move to their equilibrium value upon the advent of an economic shock and that by means of monetary or fiscal policy this adjustment process can be smoothed.

If this belief is adhered to, stabilization policy can potentially play a useful role in the response to two quite distinct sorts of events: on the one hand, offsetting temporary, cyclical fluctuations of real activity; on the other, smoothing the adjustment to permanent shocks that ultimately necessitate durable changes in the terms of trade or other relative prices.

Monetary union implies the transfer of national monetary policy to a single supranational institution and the removal of the devaluation instrument. In order to address correctly the ensuing systemic consequences for the conduct of national stabilization policy, and the subsequent questions on the need for modifications in EC public finance, the choice of a comparative benchmark is important. In accordance with the Commission's 'One market, one money' report and the conditions in the Maastricht Treaty (Article 109j) for accession to Stage III of EMU (stipulating a minimum of two years of stable membership in the EMS), the focus here is limited to the move from 'EMS + 1992' to EMU. In other words, the difference in the macroeconomic framework being considered is that between a full monetary union (EMU) and a situation where national currencies can move within the narrow 2.25% fluctuation band and where capital is free to move internationally. Admittedly, as demonstrated by the exchange-rate turbulence between EC currencies since September 1992, the long-term sustainability of this comparative benchmark may be called into question. A stable regime requires either a retrograde step towards greater exchange-rate flexibility or restrictions on capital movements or, preferably, moving to a single currency.

To explore the possible implications for EC public finance of monetary union, it is convenient to draw a distinction between EC-wide stabilization on the one hand and regional stabilization on the other.

<sup>2</sup> There is a long-standing debate among economists, with the neo-Keynesian and new classical school of thought at the extremes of the spectrum of ideas, about the sense of macroeconomic stabilization policy and the quality of fiscal policy as an anti-cyclical instrument. For an extensive discussion, see Sargent (1987) or Frenkel and Razin (1987). A brief review is provided in Majocchi and Rey (1993).

#### 4.2.1. EC-wide stabilization

The former relates to the need in EMU to ensure a budgetary stance for the Community economy as a whole permitting a policy mix with the monetary policy conducted at EC level that is adequate for internal and external balance purposes. If no attention were paid to the aggregate budgetary stance, the stabilization burden on monetary policy might be excessive, especially when, in line with what has been stipulated in Article 105 of the Treaty on European Union, the overriding aim of the prospective European System of Central Banks is the maintenance of price stability.

The central question in the present context is whether the Community budget ought to fulfil a role in the attainment of the desired aggregate budgetary stance, or whether this should be handled exclusively through policy coordination between the Member States.

Macroeconomic policy coordination is, of course, not specific to EMU. It is called for whenever national measures spill over into other countries through integrated goods and capital markets. However, besides the fact that Member States no longer possess their own monetary policy instrument to react to policy-induced disturbances from abroad, the intensity of spill-over effects is likely to be stepped up in EMU and their nature modified through a variety of transmission channels, notably the common exchange rate and current account *vis-à-vis* the rest of the world. In sum, the move to EMU will heighten the need for national fiscal policy coordination.

In all mature federal countries, it is the central government that takes care of macroeconomic stabilization for the union as a whole. The assignment of this task to the highest level of government arises from several factors. First, monetary policy is conducted at central level. Second, its budget is relatively large, equalling as a general rule roughly that of all states together.<sup>1</sup> Third, its expenditure and revenue categories exhibit a sufficient degree of flexibility: the central government is notably wholly or partly responsible for the instruments that act as the main automatic stabilizers, namely direct taxes and social security contributions and payments. Fourth, the historical context should not be overlooked: the macroeconomic field was never occupied by the states, which did not engage in active fiscal policy at home nor coordinate their policies for federation-wide stabilization purposes; when awareness of the benefits of anti-cyclical

policy grew, the federal government stepped in to fill a vacuum.

Only the first factor will be present in the Community's EMU. As already pointed out in the MacDougall report, even if the Community budget were doubled or tripled, tremendous swings in revenue and spending would have to be allowed for if it were to perform a meaningful anti-cyclical function. Ideas like that by the Marjolin Committee in 1975 for Community public finance to get involved in unemployment benefit schemes or the one developed in Albert and Ball (1983) to empower the Community to borrow for on-lending with interest-rate subsidies to the private sector are valid from the viewpoint of economic theory. However, to have a significant impact they would require budgetary orders of magnitude and rules on Community deficits that would be defensible, in the light of subsidiarity, only if the alternative in the form of national budgetary coordination proved to be unfeasible.

#### *The challenge of macroeconomic policy coordination in EMU*

If the Community economy were subject to a (more or less) symmetrical shock, calling for changes in the EC's aggregate budgetary stance, the first response would come from automatic stabilizers operating at national level. Subsequently, the Council (economic and financial affairs) should decide on possible concerted discretionary actions to achieve specific output and employment, or current account goals. Compared to the 'EMS + 1992' benchmark, such concertation should by no means be harder in EMU because, first, there will be only one monetary interlocutor and, second, the spill-over channels which will be added or strengthened by EMU do not a priori impart a deflationary or expansionary bias to domestic fiscal policy.<sup>2</sup>

The last observation ought not, however, to be taken to mean that macroeconomic policy coordination in EMU will be straightforward to carry out. A score of factors, reviewed, for example, in Cooper (1983), can seriously complicate agreements on, first, the appropriate aggregate stance at a given point in time, and, second, the distribution of the burden of adjustment towards the realization of that stance. These complications are liable to render budgetary policy coordination vulnerable to the well-known Friedman (1953) critique that, owing to the slowness of implementation, discretionary fiscal policy impinges on the economy at the

<sup>1</sup> When individual states control a budget of considerable size in relative terms and their room of manoeuvre is not constrained by binding rules, the central government's fiscal policy may at times be frustrated by deviant budgetary behaviour at subcentral level. A case in point is provided by Ontario in the Canadian federation. See Courchene (1993).

<sup>2</sup> The incremental spill-over effect induced by EMU is of uncertain sign as it is contingent on the relative magnitude of import leakage and interest-rate effects, as well as the nature of the exchange-rate regime with the rest of the world. See Chapter 5 in Commission (1990).

wrong moment, thereby amplifying, instead of attenuating, cyclical fluctuations.

Achieving effective fiscal policy coordination will doubtless be one of the main challenges in the future management of EMU. The so-called 'multilateral surveillance' procedure, operative since the beginning of 1990 by virtue of the Council Decision in March of that year, will allow very valuable experience to be gained to this end during the transitional period.<sup>1</sup>

#### 4.2.2. Regional stabilization

The main change implied by the move from EMS to a single currency is the abandonment of exchange-rate policy as a national macroeconomic adjustment instrument. However, compared to the benchmark situation, EMU makes little change to the availability of domestic monetary and fiscal policy for short-term stabilization purposes in response to temporary shocks impinging on a specific Member State.

##### *Limited effect of EMU on national stabilization capacity*

Already in 'EMS + 1992', characterized by the combination of quasi-fixed exchange rates with perfect capital mobility, the autonomy of domestic monetary policy for countries inside the system is quite limited, except for Germany whose currency fulfils the anchor role in the EMS. In EMU, the conduct of monetary policy will become more symmetric with the ESCB paying some heed — subject to the observance of the paramount goal of price stability — to the anti-cyclical policy needs of the Community economy in its entirety rather than those of the erstwhile monetary leader alone.<sup>2</sup> While 'EMS + 1992' has existed for too short a period to draw a general conclusion, the case for establishing a mechanism at EC level to compensate for the fact that in EMU the internal monetary policy instrument cannot be resorted to for country-specific anti-cyclical purposes has not been demonstrated by practical experience.

An analogous remark can be made with respect to national fiscal policy, the other traditional lever of stabilization policy. The use of domestic budgetary policy may be constrained

in EMU by the necessity to avoid 'excessive' deficits which could imperil the union's monetary stability. These constraints have been stated in the Maastricht Treaty on European Union in terms of the debt-to-GDP ratio (Member State debt levels exceeding 60% of GDP must decline to that reference value 'at a satisfactory pace'), the deficit-to-GDP ratio (with a 3% reference value) and, in a subordinate fashion, the relationship between the deficit and public investment expenditure. Although the Treaty provisions on 'excessive deficits' do exhibit prima facie a potential to impose a pro-cyclical bias on national budgetary policy, their actual effect may be considerably mitigated for two reasons.

First, they will only turn out to be a real limit to a country's fiscal policy activism inasmuch as that country's public finance position was already bordering on the danger zone prior to the advent of the cyclical negative shock. At present, few Member States enjoy sound public finances but the problem countries are expected to take the necessary measures ahead of their accession to the final stage of EMU.<sup>3</sup> Offsetting minor slumps through fiscal policy, for example by way of the national automatic stabilizers, should thus remain possible upon the introduction of a single currency.

Second, the violation of these constraints will not automatically trigger cuts in national spending or increases in taxes, but will prompt an examination by the EC Commission and Council of the causes of the trespass and of the remedial action that should be undertaken. As temporary disturbances disappear by definition after some time, the responsible EC bodies can be presumed to express a rather mild judgment on 'excessive' deficits due to purely cyclical expansionary fiscal policies.

##### *Substituting mutual insurance for the lost exchange-rate instrument*

Whilst monetary union eliminates the explicit external balance constraint at the national level at the same time as it suspends the devaluation instrument, it is important to note that it obviously does not remove a country's need to stabilize the economy upon the occurrence of shocks.<sup>4</sup>

<sup>1</sup> It may be noted that also after the entry into force of the Maastricht Treaty, macroeconomic 'burden-sharing' will continue to take place on a purely voluntary basis.

<sup>2</sup> The strains in the EMS since September 1992 were largely rooted in the fact that Germany's monetary policy of high short-term interest rates in a period of shock was considered by other EMS countries to be at variance with their own economic needs.

<sup>3</sup> As an important consequence, the Member States having to implement a public finance adjustment programme, implying the running of strong primary surpluses, will be basically unable to pursue a countercyclical policy in the transition phase.

<sup>4</sup> Nor does it eliminate a country's fundamental budget constraint, i.e. that in the longer term national income be equal to absorption. The pressure on a region in a monetary union to balance income and absorption will not appear in the guise of exhausted foreign reserves but through an increasing unwillingness of lenders to provide loans to borrowers in the indebted area. See Goodhart (1989), and Majocchi and Rey (1993).

The usefulness of the devaluation instrument in the face of negative, durable, disturbances derives from the fact that it permits authorities to 'frontload' the terms of trade adjustment as it brings about a temporary real exchange-rate depreciation when nominal wages and prices are downwardly rigid.<sup>1</sup> Its advantages ought not, though, to be overrated. For one thing, the ability to 'frontload' comes at a price in that longer-term adjustment is slowed down because the initial boost in output made possible by devaluation reduces the necessary pressure on real wages. For another, devaluation forms a crude adjustment instrument: it changes a wide-ranging set of relative goods and asset prices, many of which may not be necessary to tackle the imbalance problem at hand, possibly generating thereby undesirable side-effects.

For an economy's response to adverse permanent shocks to be successful in the long run, it needs to operate through structural channels like real wage changes, migration and occupational mobility. Cross-border migration in the EC of macroeconomic significance is not supported politically and neither is it likely owing to Europe's linguistic and cultural diversity which proves a strong impediment once income levels in the areas of potential emigration are well above subsistence.<sup>2</sup> Real wage flexibility and occupational mobility are in principle potent mechanisms which need to be enhanced in the transition to monetary union and beyond.<sup>3</sup> More specifically, it is particularly important that the introduction of a single currency should not set the stage for wage demonstration effects, as have occurred in the former GDR following German unification, engendering excessive unit labour costs in the Community's lagging regions.

However, even if factor market flexibility were reinforced and wage demonstration effects averted, it is obvious that in the face of serious economic shocks these structural channels are likely to produce a limited outcome in the short to medium term. It follows that, given the loss of the devaluation instrument, other ways to provide short-term relief need to be devised. If not, the Community economic system could come under increasing strains, as Member States hit by exogenous disturbances would show very serious difficulties in reattaining internal balance.

In existing federal and unitary EMUs regional economic disturbances are to a significant extent absorbed automatically by way of interregional budgetary flows associated chiefly with the functioning of the national social security and direct tax system (see Section 3.2). Fresh empirical analysis to this effect, undertaken in the preparation of this report, suggests that the regional stabilization capacity of federal public finance mechanisms amounts to between roughly 20 and 30%. Using regression techniques, Goodhart and Smith (1993) state that close to 20% of a loss of primary income in a US state is offset through automatic federal stabilizers. The regional shock 'offset' through federal channels is estimated to equal around 25% in Canada, whereas in the UK the tax side alone achieves a regional stabilization effect of about 20%. On the other hand, detailed simulations by Pisani-Ferry, Italianer and Lescure (1993) arrive at 17% for the USA.<sup>4</sup> By contrast, in countries like France and Germany where interpersonal solidarity mechanisms are more pronounced and unemployment transfers an exclusive national competence, the strength of automatic regional stabilization is found to rise to about 35%, climbing in Germany to over 40% when the depressed *Land* is in a position to benefit maximally from the horizontal fiscal equalization grants under the 'Finanzausgleich'.

Pointing to the existence of such mechanisms in federal countries, the MacDougall report advocated the establishment of a Community unemployment fund under which part of the social security contributions would be paid to, and part of the unemployment benefits received from, the Community. Since then, this idea or variants to it — like a European federal transfer scheme syphoning income from regions with overemployment to regions with unemployment in a budget-neutral fashion at the Community level<sup>5</sup> — have been advanced recurrently as being the first-best instrument to ensure a regional stabilization capacity at EC level. The major advantage of such schemes is that they constitute a cushion providing direct and immediate household income support, and hence demand, for regions going through a slump and that they spread part of the economic risk arising from EMU membership over the whole of the union.<sup>6</sup>

However, besides the fact that such schemes, if they were to operate along national social security lines, would need to have at their disposal contributions worth several per cent of EC GDP to generate a meaningful automatic stabilization

<sup>1</sup> See Commission (1990), Chapter 6 and Annex D.

<sup>2</sup> Besides, intra-national migration in Europe does not appear strong either. As reported in Eichengreen (1990), mobility in the USA is around two or three times as high as mobility within European countries.

<sup>3</sup> Especially in view of the sluggishness in adjustment to unemployment of EC labour markets, in comparison to labour markets in the EFTA countries, Japan and North America. See Bean (1992).

<sup>4</sup> One half of this 17% stems from the effect of social contributions. The other half is accounted for by the federal tax system, which corresponds with the finding reported in von Hagen (1991). The latter study shows that unemployment benefits do not play any cross-border stabilization role in the USA because, notwithstanding the management by the federal government, they operate at state level.

<sup>5</sup> See Van der Ploeg (1990).

<sup>6</sup> See Goodhart and Smith (1993).

effect, and that the time seems not politically ripe yet for an interpersonal redistribution function at Community level, their implementation would be fraught with serious microeconomic and managerial difficulties.

To start with, since traditional automatic stabilizers give unconditional aid which continues after a region's economic situation has stopped worsening, they are liable to create perverse incentives, delaying instead of accelerating the necessary real adjustment in factor markets.<sup>1</sup> In this way undisciplined behaviour in one Member State would be bailed out by the other Community partners, a classical example of a negative externality. Indeed, moral hazard problems of this kind also exist within the national framework, but there the pressure to tackle them is arguably much greater since with cross-border relief one is dealing with other people's money. In this context, it should also be recalled that national social security systems have emanated first and foremost from a basic equity concern and that macroeconomic stabilization is largely a valuable by-product. The idiosyncrasies of national regimes, reflecting differences in needs, labour law, and institutional set-up are huge,<sup>2</sup> such that supranational initiatives to make national systems foolproof against perverse incentives would move the Community into deep waters.

In addition, uniform levels of Community support for the unemployed may lead to very different second-round effects depending on the local labour market situation in general and wage levels in particular. Finally, managerial difficulties could be tremendous, given the already considerable problems at the national level to counter abuses and the sobering experiences at Community level with open-ended expenditure in favour of a very large number of beneficiaries, such as the CAP. National unemployment rules and their enforcement diverge widely and an effective EC control on national unemployment figures would be very hard to impose.

But there is a more fundamental problem from the viewpoint of the balanced development of the Community's economic system. If the aim of a regional adjustment lever is to compensate for the loss of the devaluation instrument, the introduction at EC level of traditional automatic stabilizers may amount to what one could call 'systemic overshooting', especially since, as argued earlier, monetary union alters little to the availability of domestic monetary and fiscal policy for stabilization purposes. Devaluation is not resorted to for each and every cyclical slump or minor shock, and should therefore be substituted for something less powerful in the stabilization policy arsenal.

Together, the foregoing arguments militate in favour of another type of cross-border support: a financial assistance mechanism offering Member States a limited, possibly discretionary, mutual insurance against the occurrence of adverse country-specific shocks that are macroeconomically significant. This proposition does not break completely new ground as it is, at least in spirit, not unlike the idea of a 'conjunctural convergence facility aimed at preventing acute cyclical problems' espoused in the MacDougall report.

A concrete *modus operandi* of a mutual insurance scheme explicitly and exclusively geared to stabilization support is outlined in Chapter 6 of this report. There it will also be shown that, contrary to prevailing beliefs on this matter, such an insurance scheme does not require considerable funds to generate a degree of stabilization 'offset' that is significant and not altogether dissimilar from what is observable in mature federal countries. The main reason for the proposed scheme's relatively strong stabilization power is that it would operate on the basis of uni-directional block grants from the Community to the depressed Member State(s), contrasting with the usual 'automatic' transfer mechanisms with an interregional incidence that are characterized by large two-way payments.<sup>3</sup>

### 4.3. Cohesion and equity in EMU

Following the accession of relatively less developed Member States, the regional dimension has been given increasing attention. This has led to the inclusion by way of the 1987 Single European Act of 'cohesion' as a Treaty objective (Article 130a). At the same time, the Structural Funds, the main vehicle of EC regional policy, were reformed and doubled in real terms over a five-year period, reaching about ECU 15 billion in 1991 or 25% of the total budget. The reinforcement of the Structural Funds was widely considered at the time as a safety net against possible dangers for the relatively less developed regions arising from the completion of the internal market. The importance of cohesion as a Community goal was reinforced in the Maastricht Treaty (Articles 2 and 3) and during the period 1993-99 the budgetary means for structural operations will be raised by another 67%. Moreover, their use will be more concentrated, such that the four poorest Member States will enjoy a renewed doubling of support.

The aim of the budgetary interventions under cohesion goes beyond a simple income transfer from rich to poor Member

<sup>1</sup> The Canadian experience offers a good case in point. See Courchene (1993).

<sup>2</sup> See Deleek (1991).

<sup>3</sup> This finding can thus be seen as the 'stabilization variant' to stylized fact (v) of Section 3.2 that explicit grants have stronger interregional equalization power.



States, which is reflected in the fact that (pursuant to Article 130b) cohesion has a non-budgetary dimension as well. It is to provide instruments to level the competitive playing field as far as structural endowments are concerned through investment programmes to upgrade infrastructure and human skills. Given its close links with efficiency, cohesion is therefore distinct from the broader concept of equity, which relates to the narrowing through taxes and transfers of the primary income gap. In brief, cohesion may be said to be about equality of opportunities, while equity is about equality of results.

#### 4.3.1. The evolution of regional disparities in the 1990s and the effect of EMU

The issues to be addressed with regard to the link between the budgetary efforts in favour of cohesion and EMU concern, first, the longer-term course of income disparities between regions and between Member States under the assumption of unchanged Community policies, and, second, the influence the establishment of EMU is likely to exert on the income gap. If there are no clear indications that disparities between the richer and poorer parts of the Community are set to widen and, *a fortiori*, if EMU is judged not to provoke a divergence of regional performances, the economic case for complementing the creation of EMU with another strong increase in the cohesion budget is weak.

A discussion of these issues should begin with the caveat that the determinants of long-term growth and regional income disparities and their evolution are complex and not yet well-understood. Different theories of international trade offer conflicting views on the effect of opening goods and factor markets on the distribution of the gains from trade among trade partners.<sup>1</sup> Conclusions on the likely development of regional disparities in the wake of the completed internal market are therefore bound to contain a large element of agnosticism.

Unlike the convergence tendency registered during most of the two preceding decades, the regional income gap has basically remained constant throughout the 1980s, as shown in Table 11, where the measure of disparity, covering 174

**Table 11**

**Disparities in GDP per inhabitant between the regions<sup>1</sup> of the Community, 1980-90**

	(in PPS, EUR 12 = 100)		
	1980	1985	1990
Average 25 weakest regions	55,0	52,6	52,3
Average 25 strongest regions	136,6	139,5	137,9
Disparity <sup>2</sup>	27,6	29,1	27,7

<sup>1</sup> NUTS, 174 regions.

<sup>2</sup> Weighted standard deviation.

Community regions (NUTS 2), exhibits a slight increase. As argued in Prud'homme (1993), the combined effects of changes in the pattern of migration, the location determinants of investment, and the size and composition of national governments' budgets are largely responsible for the renewed widening of the regional gap within Member States since the end of the 1970s, such as in Italy, France or the UK.

Although it can by no means be excluded that such structural factors may seriously frustrate the catch-up endeavours of lagging countries in the future, they have clearly not been powerful enough to abort the recent real convergence process between Member States, portrayed in Graph 3. As can be gauged from Table 12, growth in three of the four lagging Member States since the middle of the 1980s has significantly outpaced that of the Community on average. This different experience among the economically less developed Member States points to the key importance of national policies geared at reducing locational handicaps, strengthening market efficiency and macroeconomically sustainable growth. Also noteworthy is that, following German unification, real income dispersion between Member States has come down appreciably, with the average German living standard now lying much closer to the European one, and France taking over the lead in terms of prosperity among the larger Member States.

As a corollary to the observed real convergence at country-level, the lack of progress over the last decade in the reduction of regional disparities throughout the Community is almost completely attributable to developments within Member States, for which, in the light of subsidiarity and other reasons spelt out in the next section, supranational policy responsibility is obviously minor.

<sup>1</sup> The literature on this question can by and large be grouped into two rival schools of thought. The first, the 'convergence' school, building on classical and neo-classical analysis, contends that spatial disparities will tend to disappear as a result of international trade. The second, stressing the existence of imperfect competition, economies of scale, and externality factors, asserts that the reinforcement of integration is susceptible to exacerbate regional disparities owing to 'cumulative causation' processes. See Commission (1990) and Prud'homme (1993).

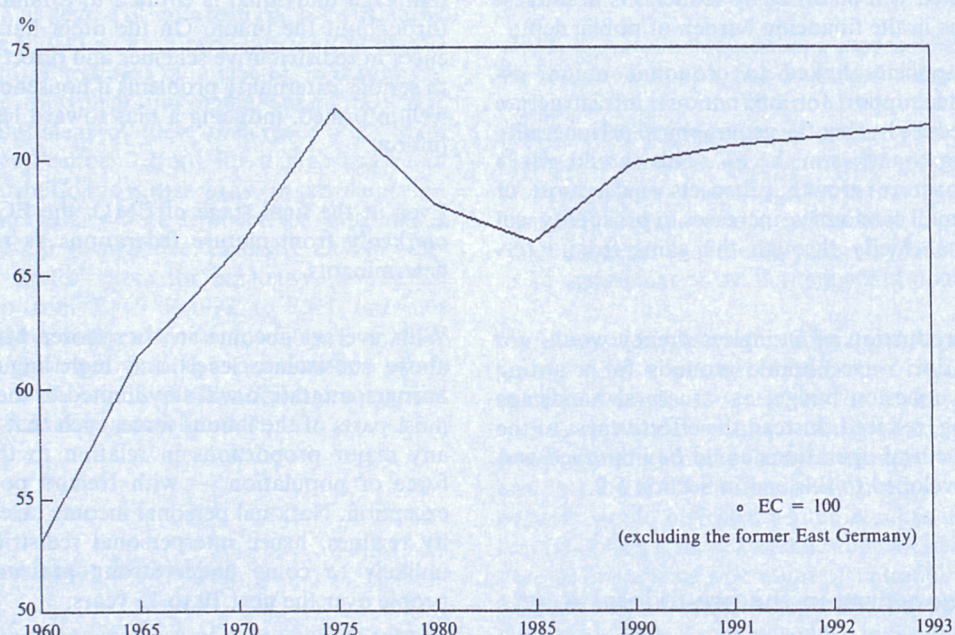
GRAPH 3: Relative GDP per capita of four least favoured countries<sup>1</sup><sup>1</sup> Greece, Spain, Ireland, Portugal.

Table 12

GDP per inhabitant<sup>1</sup> in the Member States, 1980-90

	(in PPS, EUR 12 = 100)			
	1980	1985	1990	1992 <sup>3</sup>
Belgium	106,1	104,0	104,6	108,0
Denmark	105,6	113,7	106,5	110,9
Germany	118,6	119,2	117,2	106,6
Greece	52,2	51,0	47,6	48,8
Spain	71,6	70,2	75,3	80,1
France	113,6	112,6	110,8	114,7
Ireland	60,1	61,8	68,9	73,6
Italy	102,3	102,2	102,5	106,2
Luxembourg	115,3	119,9	126,9	132,7
Netherlands	108,9	105,4	102,2	104,2
Portugal	52,6	50,0	53,6	61,5
United Kingdom	97,6	101,1	105,6	96,9
Disparity <sup>2</sup>	19,0	19,3	17,5	13,9

<sup>1</sup> Gross domestic product (GDP) per head indicates the income generated in Member States and regions by the resident producer units. An alternative measure is gross national product (GNP) per head which measures the resources available after the transfer of factor incomes such as interest payments and dividend. At regional level, data are only available for GDP per head. Net flows of transfers out of or into a country or region lead to differences between both measures which may be substantial in the case of smaller countries such as Ireland or Luxembourg.

<sup>2</sup> Weighted standard deviation.

<sup>3</sup> The figures for 1992 include unified Germany.

*Spatial distribution of EMU effects*

Much as for the Community in its entirety, a precise assessment of the net national benefits from EMU is very difficult, *inter alia* because chiefly microeconomic gains need to be weighed against the loss of a macroeconomic adjustment instrument. The as yet sparse analytical literature on this issue (Commission (1990), Santos (1993)) suggests that, whilst the stakes are highest for the relatively less developed Member States, overall they stand to gain more than average from EMU. The abandonment of the devaluation instrument, which may be relatively more important for the poorer countries as their economies are going through a profound structural transformation process unsettling their 'equilibrium' real exchange rate, is very likely to be more than compensated by a number of advantages, of which these countries will be the prime beneficiaries:

- (i) transaction cost savings and the suppression of exchange-rate variability by virtue of the introduction of a single currency are far more significant for small economies whose currencies are only marginally used as means of international payments and whose financial services sector is poorly developed;

- (ii) the loss of seigniorage revenue, which anyway will decline considerably because of the completion of the internal market, will be offset by reductions in interest rates and thus in the financing burden of public debt;
- (iii) Community policies linked to economic union, especially greater support for international infrastructure works, will reduce further the geographical peripherality of the lagging countries in the EC. This should give a long-term boost to growth prospects since, most of them being small economies, increases in prosperity will have to come chiefly through the gains from international trade.

All in all, the introduction of a single currency would not seem to call a priori on economic grounds for a strong expansion of the cohesion budget as structural handicaps appear, if anything, reduced. Instead the effectiveness of the Community's structural operations could be improved and some ideas are developed to this end in Section 5.2.

#### 4.3.2. Equity concerns in the pre-federal stage

The economic discussion on cohesion is quite distinct from the political claim that, for the sake of a balanced development of the Community, the advances toward EMU, additional competences in external affairs, and more powers for the European Parliament ought to be paralleled by steps toward greater equity. More specifically, according to this view disposable-income per capita levels of the poorer Member States need to be brought much closer to the Community average by way of public finance channels.

As the matter is one about political preferences, economic analysis has little to offer on this question, but the debate may become more focused by putting it in a 'fiscal federalism' perspective.

Indeed, in mature federations, solidarity is a key part of the federal contract, in the sense that states are prepared to abide by the constraints to their policy room for manoeuvre in exchange for the availability of redistributive mechanisms. As mentioned in Section 3.2, regional GDP per capita differentials are bridged by close to 40% through central taxes and transfers, leaving none the less differences in per capita income that are not smaller than, for instance, those between the eight richest EC Member States, comprising well over 80% of total EC population.

The need for explicit interregional transfers and/or for cross-border social security or welfare schemes is essentially determined by the degree of political homogeneity and the inter-

national mobility of individuals. The stronger the feeling of common citizenship, the more acceptable will be the idea that each individual is entitled to a minimum income level throughout the union. On the other hand, national differences in redistributive schemes and direct taxes will give rise to serious externality problems if households are mobile and well-informed, inducing a bias toward less income redistribution.

Even at the final stage of EMU, the EC is likely to differ markedly from mature federations as regards both these determinants.

With average income in the poorer Member States well above subsistence levels and high linguistic and cultural barriers, migration will stay limited to the upper and downmost parts of the labour force, such that it will not take on any major proportions in relation to the resident labour force or population — with Ireland possibly forming an exception. National personal income taxes and social security regimes, hence interpersonal redistribution, seem very unlikely to come under strong pressure from footloose people over the next 10 to 15 years.

As to political homogeneity, it needs to be recalled that the current endeavours to deepen European integration do not concern social union or political union in the conventional sense of the term. This distinguishes the EC in a critical way from the German unification process where social union supplemented EMU. Support for the needy typically proves a positive function of geographical proximity ('charity begins at home') which is why interpersonal redistribution should rather be seen as a 'local' public good to be taken care of at regional or national level (Pauly (1973)). As pointed out in Forte (1977), in policy matters related to homogeneity considerations, the 'broadest' level of government is not necessarily also the 'highest' level of government as perceived by citizens. In the pre-federal stage, where its competences still derive much more from the Member States than directly from the people, the Community lacks the political legitimacy to become more than marginally involved in social justice questions. Put differently, countries may have strongly divergent views on the proper degree of interpersonal redistribution, such that the supranational level may be argued — on the basis of subsidiarity — to have a responsibility only in interregional redistribution matters (Tresch (1981)).

As will be pointed out in Section 5.2, the Community engages in a fair amount of interregional redistribution already at present, mobilizing flows that in terms of recipients' GDP are well-comparable to those between the *Länder* in Germany (before unification) by way of the 'Finanzausgleich' and

other explicit regional transfer mechanisms. The implementation of the Edinburgh agreement will considerably augment these flows. The degree of interregional redistribution is, obviously, in the end a matter of evolving political preferences, which should be revealed by a clearer establishment of 'social union' as an explicit aim of the Community. But whatever the development of these preferences, the fiscal federalism case (see Section 3.2(iii)) for a high degree of interregional redistribution is rather weak, in particular if a mutual insurance mechanism were deployed for stabilization purposes. Although the prospective 'excessive deficit' rules will limit Member States' room for manoeuvre as regards borrowing, the step from 'EMS + 1992' to EMU does not encroach greatly upon national fiscal autonomy, with the virtually immobile tax bases yielding more than two thirds of present government revenue and the mobile tax categories becoming subject to minimum level restrictions.

#### 4.3.3. *Juste retour* and the EC budget

The fact that a significant increase of cross-border income redistribution does not seem indispensable for the success of EMU by no means implies that EC public finances as such should not display basic fairness, signifying that Member

States' net benefits are in line with relative real income per capita levels.

The budgetary fairness debate, especially the quarrels about the UK contribution, has consumed a great deal of political energy in the past. In addition, it produced two important negative side-effects: first, it tended to lead to a blinkered national assessment of Community proposals on the basis of net budgetary implications rather than on the proper merits of the proposals; and second, consideration of the costs and benefits of membership was often unduly narrowed to an assessment of the net budgetary position.

There are basically two options to tackle this problem. The first is to try to prevent it from occurring by modifying EC revenue towards progressivity or at least proportionality, and by shifts of emphasis on the expenditure side. Given its preponderance in the budget, this shift should definitely concern the CAP: reform away from product to producer support would be instrumental in achieving this effect. The second option is more systemic and would consist of a 'below the line' balancing operation of national payments and receipts to correct inequities once they have surpassed a certain threshold. Such a scheme, which was advocated in 1987 by the Padoa-Schioppa report, has the advantage of transparency but suffers also from several serious drawbacks. Our views will be spelt out in Chapter 8 of this report.



## **Part C**

# **Perspectives for Community public finance**



*The aim of Part C is to identify concrete operational implications for EC public finance with the establishment of EMU based on the foregoing economic assessment.*

*Whereas in the last chapter the analysis was structured according to the economic functions of government, this part is organized in conventional bookkeeping fashion. In Chapter 5, the Community's expenditure needs of a recurrent nature are roughly quantified and added up. Chapter 6 outlines the main features of a financial assistance mechanism providing Member States with a Community insurance against country-specific shocks, and estimates the budgetary cost of a possible stabilization support scheme. In Chapter 7, the question of which revenue sources are most appropriate to cover these various expenditures is addressed. Chapter 8 deals with the question of inequitable budgetary positions of Member States and assesses the pros and cons of different approaches to ensure budgetary fairness. Chapter 9 discusses the changed role of EC borrowing and lending operations in EMU. Part C is brought to a close by looking at ways to streamline the adoption, execution and control of the budget.*

*The highlights of the policy recommendations ensuing from the analysis developed in Part C are as follows:*

- (i) The expansion of supranational competences in the allocative and redistributive domain, required for the proper functioning of EMU, and an enhanced role for the Community in external affairs, necessitates a growth of the EC budget to between approximately 1,55 and 1,85% of EC GDP. A large part of this rise does not stem from minimum EMU conditions, but from the need to step up development assistance to LDCs and Eastern Europe, and from the inclusion of the European Development Fund in the budget proper.*
- (ii) To this must be added the expected annual outlays from a reserve fund for regional stabilization purposes, which would be activated in the event of a Member State's level of economic activity diverging substantially from the performance of the Community as a whole. A Community financial assistance mechanism explicitly designed to this end could be highly efficient, providing a degree of regional stabilization comparable to what has been observed for the USA and Canada at an average annual budgetary cost of about 0,2% of EC GDP.*
- (iii) In sum, it is recommended that overall EC expenditure should rise to between 1,75 and 2,1% of GDP over the next 15 years, implying an increase of between 45 and 75% relative to the 1992 situation.*
- (iv) In the run-up to EMU, a country's contribution to EC revenue should become proportional to its prosperity per capita. Proportionality should be ensured by means of the current 'fourth resource' based on GNP. Once it will have entered the final stage of EMU, the Community should be given access to new sources of finance. Appropriate candidates are seigniorage, carbon dioxide taxes and corporate taxes, in particular on cash flow.*
- (v) Recurrent debates on budgetary 'fairness' are unavoidable. The principle that resources should flow from richer to poorer Member States can reasonably be said to have been accepted by now as a fairness benchmark. The Community's past approach to budgetary inequity claims has been pragmatic, searching for specific solutions as the need arose. Proposals have been made to replace this case-by-case approach with a generally applicable net equity safeguard mechanism. Such a mechanism exhibits undisputed advantages, but also poses several fundamental problems. It is therefore recommended to pursue a strategy based on the flexible application of the 'resource flow' principle. The evolution of the budget, as mapped out in this report, would go a long way towards redressing and preventing the occurrence of pronounced budgetary inequities.*



- (vi) *EMU looks set to diminish strongly the relevance of EC loan instruments inside the Community. They should therefore be overhauled and reoriented towards greater risk finance and placing more emphasis on interventions in third countries.*
- (vii) *The procedure of multiannual programming by means of a 'financial perspectives' plan offers, on balance, clear advantages provided sufficient reserves are created to respond to contingencies. The involvement of national and regional authorities in the execution of the EC budget can be improved by better control and incentive mechanisms, as well as by rationalizing budgetary management rules.*

## Chapter 5

### Expenditure

#### 5.1. Enhanced Community role in resource allocation

It was stated in the previous chapter that there exists a general case for stepping up the Community's involvement in a number of microeconomic policy areas, notably the environment, infrastructure, R&D, and higher education. It turns out, however, that through a systematic application of the subsidiarity principle, the role of the EC is largely a coordination and regulatory one, and that this dimension of economic union should not entail a considerable rise in supranational spending as a percentage of EC GDP.

##### 5.1.1. Environmental protection

As can be seen from Table 13, current Community outlays for environmental purposes total about ECU 1 billion per year, or some 2% of the Community budget. Extrapolating from the available national data presented in Table 14, this ECU 1 billion amounts to approximately 2% of the sum of national public expenditure, mounting to 10% if EIB loans are included.<sup>1</sup> Current outlays can be split into basically three categories: demonstration projects, environmental research, and environmental programmes within the framework of the Structural Funds. Abstracting from the latter two, which will be dealt with presently and in Section 5.2, annual spending on the environment falls short of ECU 100 million.

Although currently minor, it is not obvious that there is a need for a massive rise in EC environmental spending. It is worth stressing once again that the Community's role with respect to environmental policy resides first and foremost in the adoption of common maximum norms of pollution and the concerted introduction of ecological taxes so as to reconcile the rational application of the 'polluter pays' principle with the integrity of the internal market. Community spending should, in the first place, be auxiliary to the elaboration of supranational regulatory norms, i.e. ensuring the technical

<sup>1</sup> Given that the figures on EC environment spending include R&D and Structural Funds expenditure whereas national expenditure concerns environmental protection proper, this 3% may be somewhat of an overestimate.

**Table 13**

**EC budget spending on environment actions**

<i>(Million ECU)</i>		
	Duration	Total
<b>Research</b>		
Environment programmes	1989-92	162
Joint Research Centre	1987-90	137
Third framework programme	1991-94	518
ECSC	1985-90	13
<b>Demonstration projects</b>		
Medspa	1986-93	63
Norspa	1991-92	14
ACE technology/ACNAT	1987-91	60
<b>Coal</b>	1987-89	74
<b>Structural Funds</b>		
ERDF (old)	1985-89	260
ERDF (Objective 1)	1989-93	1 966
ERDF (Objective 2)	1989-91	537
Envireg	1990-93	500
EAGGF 5a	1989-93	39
EAGGF 5b	1989-93	310
EAGGF forests	1987-90	58
<b>Third countries</b>		
Ecology in LDCs	1988-90	21
<b>Total</b>		<b>4 732</b>

Source: COM(91) 28.

inputs — regarding, for example, the origin and ambience of pollutants, the nature and size of negative effects or the state of product and process technology — necessary for sound policy formulation. The creation of a well-equipped European Environmental Agency would go a long way towards meeting this concern. The only apparent rationale for significant EC expenditure on environmental protection arises if EC legislation imposes binding standards and obligations, the respect of which (as indicated in some studies carried out for the Commission) would impose a considerable strain on the public finances of fiscally weak Member States.

Evidently, however, if in the future — as would be desirable — the Community as a whole rather than the Member States individually were to participate in the international undertakings to respond to global environmental challenges, and funds were to be set up by the developed world to assist LDCs in their pursuit of worldwide environmental objectives, the Community's unilateral transfers to the rest of the world may have to increase by a significant sum.

**Table 14****Expenditure on protection of the environment in the Community in 1990**

	Total (billion ECU)	As % of GDP	As % of EC total	% average growth 1980-90	% by public sector	As % of GDP
Belgium/Luxembourg	1,13	0,7	2,1	2,2	63,7	0,4
Denmark	1,16	1,1	2,2	3,9	90,0	1,0
Germany	18,65	1,6	35,3	3,3	52,0	0,8
Greece	0,27	0,5	0,5	0,5	72,1	0,4
Spain	2,93	0,8	5,5	6,5	81,5	0,7
France	9,48	1,0	17,9	3,0	66,4	0,7
Ireland	0,30	0,9	0,6	4,7	70,6	0,6
Italy	6,17	0,7	11,7	2,2	79,9	0,6
Netherlands	2,91	1,3	5,5	2,7	72,4	0,9
Portugal	0,44	0,9	0,8	3,5	86,5	0,8
United Kingdom	9,38	1,2	17,8	2,5	24,7	0,3
EUR 12	1,1	1,1	100,0	3,0	57,0	0,6

Source: ERECO.

**5.1.2. Research and development**

Standing at ECU 1,9 billion, expenditure on research and development represents about 3% of the Community budget in 1992. A fourth framework programme is currently under discussion taking into account the implications of the Maastricht Treaty and Delors II package agreed in the Edinburgh Council. These proposals envisage a gradual increase in EC R&D appropriations to ECU 4.2 billion per annum by 1997. Table 15, reporting 1990 data, shows that Community efforts amount to around 5% of what is spent by Member State governments on civil R&D.<sup>1</sup> The relative scale of EC spending compared with that of Member States, however, is much larger in three research fields, namely production, distribution and rational utilization of energy (20% of national spending), infrastructure and general planning of land use (13%) and industrial production and technology (12%).

The question of how Community spending on R&D ought to evolve can only be answered properly on the basis of a detailed examination of Europe's needs in specific research areas and the role of government in this respect. Such analysis does not lie within the remit of the present report and is in any event very difficult given the complexity of the causal link from research to the competitive strength of an economy.

<sup>1</sup> Germany, France, Italy and the UK together account for 84% of civil R&D financed by Member State governments.

Tables 16 and 17 shed some indicative empirical light on this matter by providing a comparison with the USA and Japan. It turns out that the EC trails significantly behind both competitors but this appears attributable only to a minor extent to a relative lack of R&D efforts on the part of Europe's public sector. As supranational competences in fields like energy, transport, telecommunications, the environment, etc. expand, the justification for greater Community involvement in R&D activities related to these fields will become stronger. This could signify that spending on R&D could reach over time perhaps 0,1% of EC GDP. However, relatively small public expenditure is not synonymous with lack of policy competence. As stated in Costello (1993b), the main role of the EC is to coordinate national research efforts and to create a properly functioning single market, an essential requirement for large scale industrial research.

**5.1.3. Public investment in infrastructure**

The provision of infrastructures from a purely national perspective in the EC has resulted in insufficient cross-border connections, technical incompatibilities among national networks and the failure to exploit system economies. With a single market, the volume of cross-border transport and information flows is bound to increase considerably. The EC must avoid the situation whereby infrastructure bottlenecks substitute for trade barriers eliminated under the 1992 programme. National networks need therefore to be properly interconnected. This requires in the first place concerted

Table 15

## Public expenditure on civil R&amp;D, 1991

	(million ECU)
Member States' spending	37 267 <sup>1</sup>
As % of GDP	0,72
of which on industrial technology	6 351 <sup>1</sup>
of which on utilization of energy	1 946
of which on infrastructure and general planning	
of land-use	696
of which on control of environmental pollution	1 113
EC budget	1 632
As % of GDP	0,03
As % of total EC budget	3,1
of which on industrial technology	753
of which on utilization of energy	392
of which on infrastructure and general planning	
of land-use	89
of which on control of environmental pollution	86
EC budget on R&D as % of Member States' spending	4,4
EC budget on R&D as % of Member States' spending, but on industrial technology only	11,9
EC budget on R&D on utilization of energy as % of Member States' spending	20,1
EC budget on R&D on infrastructure and general planning of land-use as % of Member States' spending	12,8
EC budget on R&D on control of environmental pollution as % of Member States' spending	7,7

<sup>1</sup> Projected.Source: Eurostat. *The Community budget: the facts and figures.*

Table 16

## Gross domestic expenditure (public and private) on R&amp;D (including defence) as a percentage of GDP (1991 data unless indicated)

	Total	Civil <sup>1</sup>
EC	1,99	1,8
Japan	3,04	2,8 <sup>2</sup>
USA	2,78	2,1

<sup>1</sup> Estimated.<sup>2</sup> 1988 figure.Source: OECD, *Main science and technology indicators* (1993).

planning and the removal of technical incompatibilities, as well as the construction of 'missing links', usually in border regions. A number of factors render it difficult to agree upon a common infrastructure policy, namely the presence of strong regional and social objectives with infrastructure provision, the close link that sometimes exists between network provision and service provision (e.g. telecommunications), and the moves in some Member States towards privatizing some infrastructures.

The presence of distribution as well as efficiency considerations with respect to infrastructure provision is reflected in current EC involvement. At present, EC public finance contributes to the development of infrastructure (telecommunications, transport and energy networks) through a number instruments: grants from the Structural Funds (and from the Cohesion Fund as of 1993), EIB loans, and (since 1990) subsidies in support of the so-called trans-European networks (TENs).

Table 17

## Percentage distribution of R&amp;D expenditure by source of financing and sector of performance, 1990

	By source of financing				By sector of performance				
	Public	Private	Total <sup>1</sup>	% of public financing spent on defence	Higher education	Government	Enterprises	Non-profit organizations	Total
EC	41,2	51,7	92,9	23,8	16,5	17,4	64,5	1,6	100
Japan	18,0	73,1	91,1	5,4	17,6	7,5	70,9	4,1	100
USA	47,1	50,6	97,7	62,6	16,0	11,0	69,9	3,1	100

<sup>1</sup> Note that total does not add up to 100% due to additional sources of financing.Source: OECD, *Main science and technology indicators*.

Following the 1990 Dublin Summit, ECU 328 million, spread over three years, was earmarked for support in the framework of the trans-European network initiative to a first list of transport network projects where clear cross-frontier gaps exist.<sup>1</sup> Article 129 of the Maastricht Treaty formally recognizes the EC's role with respect to the TENs, and spending is likely to increase (to at least ECU 1 billion per annum) in line with the Delors II package.

Investment in infrastructure, in particular as regards transport, is the most important spending item of the Structural Funds, and indeed is the largest source of EC spending on infrastructure. Such spending will increase in coming years with the commitment to increase transfers from the Structural Funds to Objective 1 regions. Furthermore, the Cohesion Fund will allocate ECU 15.15 billion for spending on transport infrastructures and environmental projects between 1993 and 1999 to the four cohesion countries (Spain, Greece, Ireland and Portugal). None the less, the infrastructure endowment gap between core and lagging regions is so great that even these increased levels of transfers will not eliminate such differences except over the very long term.

Financing infrastructure networks is also the EIB's principal field of activity, lending more than ECU 12 billion in 1992 to this end.<sup>2</sup> The role of loans as supranational financial instruments in EMU will be discussed in Chapter 9.

The federal governments of several federations finance infrastructures of national interest through specific-purpose grants to sub-central governments. Nevertheless, several considerations suggest that Community aid to underpin infrastructure projects outside regions eligible under the Structural Funds need not undergo a steep rise. First, as already noted in Section 4.1.1, an increasing share of infrastructure is provided by private sector utilities whose investments are recouped by user fees. A case in point is the Channel tunnel which despite the size of the undertaking will be realized without public grants. Second, the Community interest in principle is confined to the cross-border sections of the networks, and thus fall under the scope of the TENs initiative. Finally, although their scale may be hard to determine precisely, the country-incidence of spill-overs should be relatively straightforward to ascertain, which should facilitate the reaching of agreements among the interested Member States without a financial input from the supranational level.

<sup>1</sup> This list includes the interconnection of high-speed rail networks, Alpine transit routes, trans-Pyrenean road links, road links with Ireland, and 'Scanlink'.

<sup>2</sup> The large part of Community support occupied by debt finance on advantageous terms deriving from the Community institutions' credit-worthiness, accords with the well-established notion reflected in the 'golden' rule of public finance that for the sake of fair burden-sharing among generations public infrastructure should be funded by borrowing.

#### 5.1.4. Education

Much the same can be said about the budgetary implications of the Community role in the field of higher education.

Here the main task is to contribute to the lowering of professional and cultural barriers to the movement of human capital by promoting cross-border mobility of students and teaching staff, cooperation between universities, and the learning of foreign languages. Already, EC measures have been taken laying down minimum requirements permitting the mutual recognition of diplomas and other professional qualifications. But it is also economically justifiable for the Community to bear the specific costs of mobility.

The Community currently spends some ECU 150 million per year on higher education by means of the Erasmus, Comett, and Lingua programmes.<sup>3</sup> The most important in budgetary terms is Erasmus, which has proved a remarkable success testifying to the vivid mutual interest of the Community's young intellectual elite. It confers mobility grants to 4% of the EC's student population, but looks underfunded if the aim is to cover a larger share of mobility costs than at present and to reach a 10% level of beneficiaries, a level often put forward as some sort of critical threshold to engender a palpable 'Europeanization' of national academic curricula.

These observations would suggest that another ECU 500 million per annum or thereabout, in 1991 prices, should be enough to cater for the Community's financial needs to foster the cross-border dimension of higher education in the period under consideration.

#### 5.1.5. Financing CAP reform

The CAP is the Community's largest budgetary item, still absorbing nearly 60% of total annual expenditure. Since its inception in the early 1960s, its emphasis has gradually come to lie overwhelmingly on 'ensuring a fair standard of living for farmers' (pursuant to Article 39 EEC). The CAP has essentially become an instrument providing assistance to a declining sector.

Like in many other developed economies in the past, this assistance has until now primarily taken the form of price support, as distinct from direct income support unrelated to production.

<sup>3</sup> Erasmus fosters the mobility of students in the Community and greater cooperation between universities. Comett supports the cooperation between universities and industry regarding advanced technology training. Lingua is designed to improve foreign language training and teaching.

Although it displays a number of attractive features from a management point of view, price support has a more damaging impact on economic welfare than direct income assistance because it induces larger resource allocation distortions on account of the fact that it influences the consumption side as well.<sup>1</sup> As set out in Munk (1993), this negative welfare effect will grow worse, *inter alia* as the economy becomes a net exporter and the price elasticity of farmers' supply grows higher. Besides, as it is linked to production, the income transfer arising from the CAP is inequitably spread, with the largest farms absorbing the lion's share of transfers: roughly 20% of farmers obtain about 80% of support.

However, for a given level of help to the agricultural sector, the visible budgetary cost of a price support scheme, even including storage expenses and export subsidies, will be smaller than direct income assistance because price interventions transfer income chiefly from consumers to producers instead of directly from taxpayers. This is well-illustrated by the OECD finding that, of the total support received in 1990 by the agricultural sector through the CAP, only 25% came from taxpayers.<sup>2</sup> The remaining 75% was borne by consumers.

The combined effect of rapid increases in agricultural productivity (imposing a heavy burden on the environment), the low elasticity of demand, and pressure from third countries which often possess a comparative advantage over EC farming, renders the strong reliance on price support increasingly untenable.<sup>3</sup> For the sake of economic efficiency, international trade, and the environment, the CAP has to be drastically reformed towards direct income assistance, even though the political and administrative challenge this raises ought not to be underestimated.

A shift from price to income support would have far-reaching implications for the role of the EC in agriculture. Direct assistance would make a 'common' internal policy redundant as it is not dependent on border or analogous measures. In the short to medium term, direct income support would need to come from the Community budget in order to ensure the reform's political acceptability in the countries strongly benefiting from the CAP at present. Community assistance, which evidently would not discriminate on the basis of nationality, could be topped up by the Member States themselves. However, given the arguments set out in Section 5.2 below, that the supranational level of government should

play a limited role in redistribution, Community assistance should decline over time, at least in relative terms.

In the long run, the position of agriculture in the internal market should become similar to that of other sectors enjoying government support such as shipbuilding, textiles or coal. There, the EC's task, apart from determining the common external trade regime and removing market access barriers, is basically confined to imposing boundaries on national State aids in order to safeguard fair competition.

As previously remarked, direct income support occasions, *ceteris paribus*, a larger budgetary cost. However, over time circumstances will change, in particular because of the age profile in the sector which is strongly skewed towards old farmers. Moreover, support should grow increasingly targeted with direct income assistance becoming inversely related to agricultural households' comprehensive income and wealth.

Last year's CAP reform measures centred on a revision of the price support scheme through cuts in intervention prices, the introduction of new production quotas and the tightening of existing ones. Nevertheless, they also make a bold attempt to widen the role of direct income support linked to 'set-aside' programmes which leave fields uncultivated, or to specific environment-friendly uses of the land. They therefore constitute a first step in the recommended direction of reform, paving the way for further initiatives. The latter will no doubt need to be forthcoming should the Uruguay Round negotiations be successfully concluded in December 1993.

The budgetary cost of price support schemes is difficult to predict with a reliable degree of accuracy because it depends strongly on volatile, exogenous factors, such as the price level on world markets or the dollar/ecu exchange rate. Bearing in mind this caveat, and assuming the reform measures of 1992 to be fully implemented, the CAP has been estimated to cost in 1997 ECU 39 billion at 1992 prices, or roughly 25% up in real terms from expenditure in the latter year. If this estimate is correct, there is potential for a crisis with regard to the CAP in the second half of this decade, since the Edinburgh agreement, apart from bringing additional expenditure items under the agricultural budget line, has foreseen ECU 37 billion only.<sup>4, 5</sup>

<sup>1</sup> Price support policies are associated with lower administrative costs since they do not require controls at the level of the individual farmer.

<sup>2</sup> This analysis is based on the so-called 'producer subsidy/ consumer subsidy equivalents'. See OECD (1991).

<sup>3</sup> In addition, as argued in Chapter 11, the accession of Eastern European countries to the EC would cause agricultural spending to soar under current CAP rules.

<sup>4</sup> The likelihood of overruns for the agricultural budget raises an important question of budgetary discipline and the adequacy of existing rules to this effect. See Section 10.1.

<sup>5</sup> The underlying assumptions as regards economic growth rates, exchange-rate movements and coverage of the eastern *Länder* differ between the two estimates, such that the divergence is not as great as appears at first sight. In any event, the European Council has agreed to provide extra financial resources for the CAP as a result of exchange-rate turbulence and to cover unforeseen expenditure resulting from CAP reform.

The view of this report is that by gradually decreasing the role of the Community relative to the Member States through more focused assistance measures, and by virtue of the greying of the farming population, it should be possible to proceed with a more pronounced switch to direct income support with a broadly constant real volume of CAP spending. Assuming GDP will grow at 2,5% per annum, this should enable the weight of CAP spending in terms of Community GDP to be brought down to 0,4 to 0,5% in 2000 and the following years, compared to the 0,6% share in 1999 allowed for in the Edinburgh agreement.

## 5.2. The future size and functioning of the Structural Funds

It was stated in Section 4.3 that, although the relative ignorance about the determinants of long-term growth call for caution, a slide of the real economic performance of the lagging Member States compared to the rest of the Community purely as a consequence of the establishment of EMU appears rather unlikely. From an economic point of view, there cannot be an automatic linkage between EMU and the size of transfers, the more so if they become macro-economically important, since they would then carry the risk of inducing dependency.

A case can be made for stepping up the degree of redistribution between Member States for the sake of a better political balance in the deepening of the Community's integration process. However, so long as the objectives of social union are not more clearly defined and agreed and national public spending and taxing powers are not much more constrained than currently is likely, the Community ought not to get seriously involved in unconditional fiscal equalization schemes, let alone systems of cross-frontier interpersonal redistribution. As a corollary, the reinforcement of solidarity should preferably be manifested through an increase of the budget line for structural operations.

All the same, for the EC Structural Funds to contribute better than at present to the aim of cohesion, expanding their size may not be sufficient. An overhaul of their functioning is equally necessary. If not, the Structural Funds, which are meant as conditional specific-purpose grants, risk remaining what they have largely been hitherto: a set of disguised block grants, which on account of the rather complex nature of implementation procedures may not always have produced an efficient outcome.

The Edinburgh provisions and the reform of the Structural Funds adopted in 1993 already go some way in the right direction, e.g. with regard to a higher regional concentration

of support and a stronger emphasis on *ex ante* evaluation. But further improvements are needed and possible, centring on a shift from input to performance conditionality, including the deployment of economic measures that are not directly related to the Structural Fund programmes proper.

### 5.2.1. Present characteristics and redistributive effect

In accordance with the Brussels budgetary agreement of 1988, the Structural Funds, consisting of the European Regional Development Fund, the European Social Fund and the Guidance Section of the EAGGF, were doubled in real terms and will attain ECU 20,5 billion, i.e. around 0,3% of GDP or between 25 and 30% of the budget in 1993. Moreover, pursuant to the cohesion protocol in the Maastricht Treaty, the Cohesion Fund has come on stream in 1993 with a budget of ECU 1,5 billion, such that, on the whole, structural outlays currently claim one third of the budget. Following the Edinburgh agreement, this share is due to increase further to between 35 and 40% by 1999, being equivalent to almost half a per cent of EC GDP on present forecasts.

#### *The reforms of 1988 and 1993*

As a consequence of the Single European Act, the Structural Funds also were reformed so as to enhance their effectiveness in the realization of five broadly defined objectives, whose budgetary weight is laid out in Table 18. Three of the objectives have a regional profile, the other two being geared to the labour market. The regions of Objective 1 are characterized by a purchasing power per capita below 75% of the Community average and currently comprise about 21% of the EC population.<sup>1</sup> In the 1989-93 period they will have received over 60% of Structural Fund outlays. Aid to Objective 2 regions, areas confronted with industrial reconversion problems and covering another 16% of the population scattered over all Member States,<sup>2</sup> represents 10% of Structural Funds spending, as does support to agricultural and rural areas. Efforts in favour of the long-term unemployed and the insertion of youngsters in the labour market account for another 10%.

The main operational novelty of the 1988 reform has been the introduction of the so-called Community support frameworks, elaborated on the basis of recipients' development

<sup>1</sup> The Objective 1 zone is currently formed by the whole of Ireland, Greece and Portugal, large parts of the Spanish south and north-west as well as the Canary Islands, the Mezzogiorno, the French overseas departments and Corsica, and Northern Ireland. It will undergo some minor changes for the period 1994-99.

<sup>2</sup> Except, of course, the three Member States that fall in their entirety under Objective 1.

programmes. These frameworks reflect a 'partnership' approach attempting to incorporate Community, national and regional initiatives. In addition, they provide for a multi-annual planning of expenditure, thereby assuring Member States of the stability and predictability of EC interventions.

The changes introduced in 1993 with regard to the Funds' *modus operandi* for the period 1994-99 are relatively minor. The debate on them was overshadowed by Member States' discussions with the Commission to secure themselves a 'fair' share of the ECU 155 billion to be transferred through the Structural Funds and the Cohesion Fund during that period.<sup>1</sup> Apart from providing for some managerial improvements and simplification in the decision-making procedures on development plans and operational programmes, as well as stressing the need for a better *ex ante* and *ex post* appraisal of structural interventions, the new regulations merge the former Objectives 3 and 4 and create a new Objective 4 aimed at facilitating the adjustment of workers to industrial change and the evolution of production systems.

**Table 18**

**Structural Funds breakdown by Objective**

Objective <sup>1</sup>	1989-93 (billion ECU at 1988 prices)	%	1994-99 (billion ECU at 1993 prices)	%
Objective 1	37,0	63	96	68
Objective 2	6,4	11		
Objectives 3 and 4	7,2	12	45	32
Objective 5	6,0	10		
Other	1,7	3		
Total	58,3	100	141	100

<sup>1</sup> Objectives under the 1989 reform:

- 1 Promotion of development and structural adjustment in less developed regions, defined as those with a GDP per capita lower than 75% of the Community average.
- 2 Rehabilitation of regions affected by industrial decline, defined as regions with above average unemployment plus industrial employment which is above average but declining.
- 3 Reduction of long-term unemployment.
- 4 Occupational integration of the young.
- 5a Speed-up of agricultural adjustment.
- 5b Promotion of rural development.

Under the 1993 reform the existing Objectives 3 and 4 are amalgamated and a new Objective 4 is created for the adjustment of workers to industrial change.

Source: Commission of the European Communities (1989b), conclusions of Edinburgh Summit and own calculations.

<sup>1</sup> Unlike most federations where the distribution of grants to recipient regions is a function of predetermined and objectively applicable formulas, the Commission has some room for manoeuvre with regard to the indicative breakdown by country of Structural Fund commitments. More specifically, the Council Regulation mentions the variables to be taken into account, but their eventual relative weight is largely at the discretion of the Commission.

*Economic attributes*

The current shape of the Structural Funds displays several salient features. First, the degree of concentration is not very pronounced, as can be inferred from Table 19, with the four lagging Member States obtaining only around 52% of transfers.<sup>2</sup> However, by virtue of the Edinburgh agreement, and more specifically the decision to double aid to the four cohesion countries, this degree is due to rise by 1999 to nearly 60%.

Second, the Funds intervene by way of matching grants which, given the predetermined ceilings in the EC budget's financial perspectives, are of a closed kind. As will be set out in Section 5.2.3, the lack of open-endedness of matching grants may pose so-called additional problems. The proportion of financing depends on the type of investment and whether the beneficiary is the local government or a private enterprise. Support to the private sector, taking primarily the form of direct investment aid or the improvement of the financial conditions of starting firms and the self-employed, accounts for respectively 15 and 35% of interventions in favour of Objective 1 and 2 regions.

Third, Funds' interventions are to a very large extent subject to national quotas by objective, with indicative allocations adopted by the Commission in 1989 and again in 1993 for the period 1994-99. The captive nature of the money available is liable to weaken the eligible regions' efforts to act in conformity with the specific purposes of Structural Fund interventions.

Fourth, conditions attached to Structural Fund interventions are microeconomic. They have broadened following the shift from project to programme support. However, they are still exclusively linked to the specific regional development plan, and do not concern other microeconomic areas or the conduct of macroeconomic policy. Yet, the general economic context is crucial for investment in physical and human capital to achieve an optimal return. The Cohesion Fund, accounting for 7% of total structural expenditure in 1993, is distinct in this regard as it will be subject to macroeconomic conditionality. The macroeconomic proviso relates to the public finance situation of the recipient country and stipulates that the Cohesion Fund transfers will cease if the Member State in question is found by the Council to have an excessive deficit and has taken insufficient measures to eliminate the latter within a specified period.

<sup>2</sup> The limited redistributive focus until now is largely explained by the regional, as distinct from the national, approach of the Funds, in conjunction with the political strategy to secure sufficient support in the Council by serving all Member States.



Table 19

Member States' receipts from the Structural Funds under the Community support framework 1989-93, and relative prosperity levels

	Percentage distribution of financial allocations	Percentage share in EC population	GDP per capita expressed in PPS, 1990 data
Belgium	1,4	3,0	102,8
Denmark	0,6	1,6	105,1
Germany	5,4	19,4	112,4
Greece	11,7	3,1	53,4
Spain	22,5	11,9	76,7
France	10,6	17,2	108,5
Ireland	6,4	1,1	68,8
Italy	17,5	17,6	104,0
Luxembourg	0,1	0,1	124,2
Netherlands	1,3	4,6	103,8
Portugal	12,3	1,4	56,2
United Kingdom	10,25	17,5	105,4
EUR 12	100,0	—	100,0

Source: Commission: Annual report on the implementation of the reform of the Structural Funds; Commission statistics.

### Redistributive effect

Explicit grants form only part of the redistributive dimension of intergovernmental financial relations and may convey a misleading picture when looked at in isolation.<sup>1</sup> Bearing this caveat in mind, it is none the less useful to shed light on the redistributive effect of the Structural Funds once their reform and doubling will have been fully implemented, and compare this effect to that generated by the German 'Finanzausgleich', which is often referred to as a model for the Community's future pattern of solidarity, or to the wider set of interregional equalization mechanisms in Germany involving the Finanzausgleich, the regional bias in the sharing of VAT proceeds among *Länder*, the 'Ergänzungszuweisungen' (vertical general purpose grants) and the 'Strukturfürhilfen' (vertical specific purpose grants for infrastructure). Concentrating on the five principal recipient *Länder* and Member States, Table 20, based on calculations in Costello (1993c) presents the results of this comparison. The German data relate to 1990 and thus concern the former Federal Republic; obviously, the picture deriving from Table 20 is likely to undergo drastic changes in the wake of unification.

<sup>1</sup> The overall redistributive effect of EC public finance is, aside from the Structural Funds, determined essentially by the country incidence of the CAP and VAT. As far as Germany is concerned, the powerful redistributive impact of federally based personal income taxes and the social security system ought not to be overlooked.

If one considers the four explicit interregional mechanisms combined — the last two columns for Germany — net transfers as a percentage of GDP of the beneficiary *Länder* are quite similar to those measured for the Community through the Structural Funds: the four poorest *Länder* obtain between 0,83 and 2,92%, whereas their counterparts among the Member States enjoy a transfer ranging from 0,46 to 2,81%. However, the difference between the Community and Germany is striking in terms of the redistributive effect, i.e. the percentage by which the initial per capita income disparity of poorer regions relative to the average level is reduced.<sup>2</sup> This is attributable to the strongly divergent scale of regions' primary income differentials. The relative homogeneity of income per capita in Germany implies that much larger redistributive effects can be realized with basically the same interregional flows in terms of GDP. Whereas the reduction of income disparities benefiting the four lagging Member States lies between 1,89 and 5,29%, corresponding figures for Germany amount to 6,03 and 16,79%.

### 5.2.2. Yardsticks for the further growth of the Structural Funds

The decision to double the real volume of the Structural Funds for the period 1989-93 in parallel with the completion of the internal market was the outcome of an intense political negotiation process. By the same token, the accord to increase the overall budgetary means for structural operations by another 51% in real terms between what was agreed in 1989 to be the level for 1993 and the figure for 1999, was also the result of 'North-South' bargaining between the Member States. This bargaining is quite legitimate as the shape and size of cross-border redistribution mirrors the degree of political and social unity within the Community.

By assessing the budgetary implications of the pursuit of predetermined, quantified, cohesion policy objectives, normative orders of magnitude can be advanced that allow an empirically meaningful light to be shed on this inherently political question. In what follows, two alternative routes will be briefly explored. Given that the Community has not yet fixed its cohesion policy objectives in a precise manner, the results obtained from them serve only an illustrative purpose.

<sup>2</sup> The redistributive power of transfers is strongly influenced by the degree of initial income disparities. If, for example, per capita income is increased from 98 to 99%, the redistributive effect equals 50% ( $100 * (2 - 1)/2$ ); in contrast, the redistributive effect of a transfer raising per capita income by one percentage point from 50 to 51% is a mere 2%.

Table 20

Net redistribution impact of explicit interregional flows in Germany<sup>1</sup> and the European Community<sup>2</sup>

	Germany					European Community			
	GDP per capita in terms of national average	Finanz-ausgleich		All explicit interregional mechanisms		GDP per capita in terms of EC average	Net receipts as a % of GDP <sup>3</sup>	Redistributive effect <sup>4</sup>	
		Net receipts as a % of GDP <sup>3</sup>	Redistributive effect <sup>4</sup>	Net receipts as a % of GDP <sup>3</sup>	Redistributive effect <sup>4</sup>				
Bremen	125,7	1,96	-9,60	2,63	-12,89	Greece	52,2	2,81	3,06
Niedersachsen	83,9	0,82	4,25	1,77	9,20	Spain	80,5	0,46	1,89
Rheinland Pfalz	88,0	0,39	2,85	0,83	6,03	Ireland	69,0	2,38	5,29
Saarland	85,2	1,05	6,01	2,92	16,79	Italy	104,0	0,00	0,07
Schleswig Holstein	82,7	0,73	3,33	1,71	7,75	Portugal	57,1	2,72	3,62

<sup>1</sup> German data relate to 1990.<sup>2</sup> EC data are forecast for 1992.<sup>3</sup> Net receipts are Structural Funds' disbursements minus beneficiaries' contributions to the financing of the redistributive flows.<sup>4</sup> The redistributive effect measures the percentage by which initial income disparities are reduced.*'Top-down' approach*

The first, already employed in the Padoa-Schioppa report and, more recently, in Begg and Mayes (1991), draws on a very simple growth model and considers how much additional investment in the lagging countries/regions is required to generate the extra growth necessary to close part of the real income gap with the Community average over a certain number of years.<sup>1</sup> The underlying computational method offers an interesting and simple perspective on long-term growth, but it should be remarked that it is obviously much too crude to shed any light on the weight of infrastructure or human capital relative to directly productive equipment, or on the share of the public relative to the private sector, or on the distribution between foreign and domestic capital, in the required increase in investment.

<sup>1</sup> Padoa-Schioppa report, Annex E. If one posits the link between growth and investment to be in the form of the following relation:  
 $Q/Q = Q/I \times I/Q$ .

GDP growth can be broken down in two parts:  $Q/I$ , or the marginal efficiency of investment; and  $I/Q$ , or the ratio of net investment to output. This relation, which rests on a number of simplifying assumptions relative *inter alia* to technological progress and capacity utilization, establishes a mechanical link between growth and the investment. Assuming, for example, a marginal efficiency of investment of 0,25, an additional 1% growth in GDP will necessitate a rise in the net investment ratio of 4 points (e.g. from 10 to 14%). Net investment needs were converted to gross fixed capital formation requirements on the basis of the relationship in the recent past between net and gross investment.

Focusing on the four countries whose real income per capita trails behind the Community average by a wide margin, Table 21 indicates by how much annual gross investment needs to rise in 1991 prices for Greece and Portugal to reach, in 20 years' time, 75% of the Community average, Ireland 80% and Spain 85%, it being assumed that EC GDP grows by 2,5% per annum.<sup>2</sup> According to this simple growth model, the Greek economy, for example, has to expand by 1,8% per annum in excess of the Community as a whole to attain the 75% goal by 2011. Depending on the height of the country-specific marginal efficiency of investment, which in the Greek case was taken to lie between 0,15 and 0,25, the investment ratio needs to go up by between 7 and 12 points, translating into a requisite ECU 9 to 15 billion increase of annual gross capital formation at 1991 prices.

These 'top down' calculations suggest that in order to achieve the just mentioned catch-up objectives for the four countries under consideration, a supplementary yearly capital injection of around ECU 30 to 40 billion is called for. Obviously, the latter need is lessened if by virtue of, for

<sup>2</sup> In this computation both the slightly faster than average population growth in the less developed Member States and the likely worsening of the PPS exchange rate owing to the rise of the price of non-traded relative to traded goods have been ignored.

example, policies to improve labour skills or microeconomic measures toward a better allocation of resources, governments succeed in raising the marginal efficiency of investment. At any rate, this numerical exercise points to the challenging task ahead, especially for the three poorest Member States, to augment considerably their investment efforts if they are to stand any real chance of catching up. EMU should facilitate this task by loosening the link between domestic savings and investment with the disappearance of the explicit balance-of-payments constraint. Viewed from this angle, the lagging Member States have every interest in attempting to become full participants in the monetary union

as soon as possible, despite the fact that the right to entry into the final stage has been made conditional on satisfactory 'convergence' performance, especially with respect to inflation and government deficits, the achievement of which may entail some transitory deflationary problems subduing growth.

In any event, the Structural Funds could make a vital contribution to intensifying investment efforts, in particular as far as the public sector component is concerned, which the other approach takes a closer look at.

**Table 21**

**Gross capital formation requirements for partial catch-up between 1991 and 2011**

	Requisite growth excedent relative to Community average (%)	Required increase of net investment ratio	Increase in annual gross capital formation (billion ECU, 1991 prices)
Greece: from 53 to 75%	1,8	7,2 to 12,0	9,1 to 15,0
Portugal: from 57 to 75%	1,4	5,6 to 8,3	6,2 to 9,0
Ireland: from 69 to 80%	0,76	3,0 to 5,2	1,9 to 3,2
Spain: from 79 to 85%	0,38	1,5	12,9
Total			29,7 to 40,0

#### *'Bottom-up' approach*

A second path to come to economically sensible orders of magnitude for the further expansion of the Structural Funds is through a 'bottom-up' approach quantifying public investment requirements in the Community's backward areas to endow them with an infrastructure similar to that in the EC's most developed regions. There is a growing economic literature highlighting the link between public investment on infrastructure and the rate of economic growth.<sup>1</sup>

Several expert reports, reviewed in Costello (1993b), have been written on various aspects of the infrastructure gap separating the lagging regions from the rest of the Community. In principle, the analysis ought to encompass the former GDR as well, on account of the high degree of obsolescence of the latter's infrastructure: however, the lack of comparable data precludes this. The studies only provide

a rough, mechanical quantification of the volume of public investment necessary to bridge that gap. However, they do not offer an economic analysis of investment needs, which arguably would lead to lower estimates.<sup>2</sup>

An early study on the infrastructure endowment gap in the Community was undertaken by Biehl (1986),<sup>3</sup> and concluded that, even allowing for differences in population densities, transport infrastructure in lagging regions was only 50 to 55% of the level in the rest of the Community. A more recent study carried out for the Directorate-General for Regional Policies estimated that telecommunications infrastructures in Objective 1 regions will lag by ECU 40 billion

<sup>1</sup> For example Winston Clifford (1991), 'Efficient transportation infrastructure policy', *The Journal of Economic Perspectives*, Vol. 5, No 1, winter 1991.

<sup>2</sup> There is no economic justification for having identical levels of infrastructure in all regions. The decision to invest in infrastructure should depend upon the net present value of expected returns. As this value will almost certainly lie higher in 'core' regions, one would therefore expect a higher level of investment endowment.

<sup>3</sup> Biehl D (1986), *Study on infrastructure endowment, infrastructure financing and regional development*, study carried out for DG XVI of the European Commission.

behind the rest of the Community by 1994.<sup>1</sup> A further study examined the investment required in Objective 1 regions on environmental infrastructures if EC and international environment standards are to be respected. According to this report, Objective 1 regions will need to invest some ECU 18.5 billion over the period 1993 to 2005 to fulfil commitments with respect to urban water waste, industrial water waste, urban solid waste and industrial solid waste. Other studies also indicate a substantial infrastructure endowment gap between Objective 1 regions and the rest of the Community with respect to energy and education infrastructures.

The consequences of this observed scale of the infrastructure endowment gap between lagging and core regions for annual Community structural expenditure to the benefit of Objective 1 regions should depend, first, on the desired time-frame to bridge the gap. A gradual approach may be advisable to avert serious absorption capacity problems, which would conflict with nominal convergence aims. A second factor is the intensity of support. In line with the arguments set out in Section 5.1, the Community's participation rate would clearly be higher for human resource development and transport than for energy or telecommunications where investment can be more easily recuperated through user charges.

### 5.2.3. Additionality and functional improvements

Apart from assuring a better coherence and predictability by means of the Community support frameworks, a second major aim of the 1988 reform was to reinforce the real impact of Community grants on national and regional spending on public investment or training, i.e. to improve the Funds' additionality.

An intergovernmental grant that is meant to promote spending on specific purposes is additional if the grantee would not have made the expenditure in the absence of the grant. If not, it will have basically the same effect as a general-purpose grant and merely bolster the recipient government's revenue. Such transfers fulfil a redistributive function but the resource allocation role is lost. As discussed in Spahn (1993a) and Costello (1993a), economic theory states that the best, though not foolproof, manner to ensure additionality is by way of conditional matching grants with variable rates for different jurisdictions, because by lowering the marginal price of the favoured goods they induce a substitution effect

on top of the income effect.<sup>2</sup> However, the achievement of additionality is virtually impossible to ascertain in practice as it is bound to rest on a counterfactual reasoning.

The additionality principle was given an operational content in the 1993 revision of the 1988 regulations, stipulating that Structural Funds may not replace public expenditure on structural or comparable expenditure undertaken by a Member State.<sup>3</sup> More specifically, a Member State is held in principle to maintain its expenditure at least at the same level as in the previous programming period, i.e. 1989-93.

### *Operational pitfalls of additionality objective*

Despite this provision, there exist several reasons why the Structural Funds in their present shape are unlikely to generate much additionality. First, the shift from project to programme support inspired by well-founded managerial considerations and concerns about the coherence of Fund interventions, in conjunction with the wish to avert regional absorption capacity problems or sectoral overheating, have led to rather broad definitions of eligible support. Together with the closed-ended nature of the Funds, this tends to render assistance rather easily fungible with other types of spending. This holds in particular when EC aid is relatively minor compared to national budgetary outlays on the supported items.

Second, notwithstanding the ultimate regional destination, Structural Funds are transferred through the national governments which may wish to substitute EC money for their own grants to regional authorities, at least as far as increments are concerned.

Third, experience has shown that the *ex ante* establishment of national shares, which is *de facto* the current practice, creates a presumption of automatic entitlements, undermining strongly the purpose-specificity of grants.<sup>4</sup>

If Structural Fund transfers are rather easily fungible, it implies not only that they do not have much of an allocative

<sup>1</sup> Ewbank Preece (1991), *Telecommunications investment requirements of Objective 1 regions, 1991-2000*, study carried out for the EC Commission, Directorate-General for Regional Policies.

<sup>2</sup> It should be noted that matching grants are not necessarily optimal from a grantee's point of view. A block grant may permit the attainment by the recipient of a higher indifference curve, but then with a smaller consumption of the goods favoured by the grantor. Since the interests of the higher and lower levels of government may thus conflict, the net effect of conditional matching grants in terms of welfare theory is indeterminate.

<sup>3</sup> Regulation (EEC) No 2082/93.

<sup>4</sup> In addition to these three reasons, additionality is hard to enforce operationally. The data for the verification of compliance with additionality are submitted by the interested country itself. No sanctions have been foreseen, at least not explicitly, in the event of non-respect.

role, but also that the use of criteria of regional need may cause an improper distribution of funds.<sup>1</sup> For instance, inasmuch as aid to the Mezzogiorno is fungible, it benefits the whole of Italy, whose GDP per capita exceeds that of the Community average. As a corollary, a case could be made for taking into account as well the overall national position in setting eligibility norms, in lieu of regional backwardness only.

### *Recommendations for further reform*

The Edinburgh decisions, along with the 1993 revision of the Structural Fund regulations, have addressed a number of weaknesses in the Funds' past functioning. Support will be more concentrated on the poorest Member States. The rules with regard to national programming have been made more flexible and, as a counterpart to this greater national autonomy, the role of *ex ante* appraisal and *ex post* evaluation of Community assistance has been strengthened. Quality control, preferably by independent expert bodies that use scientifically sound methodologies for programme assessment form an indispensable building-block for enhancing the effectiveness of cohesion efforts. Yet, essential as it is, it will also be a major challenge in that hitherto the absorption of favourable Structural Fund support was often considered a sufficient indicator of success.

Two supplementary recommendations for improving the Structural Funds' *modus operandi* follow from our earlier analysis.

First, as securing project-related or programme-related additivity turns out elusive, it would seem appropriate to subject transfers to broader micro- or macroeconomic conditions, at least with regard to those countries whose revenue from the Structural Funds is significant relative to national GDP. Such conditions could include measures to promote greater goods and factor market flexibility, tax reform, or changes in the conduct of budgetary policy. Cast in more general wording, the Funds should become more performance-related rather than expenditure-related.<sup>2</sup>

Secondly, and complementary to the latter proposal, ways should be found to ensure that the Funds are not fully exhausted by national quota allocations, such that there are positive incentives for potential beneficiaries to compete on

the basis of the merits of submitted programmes, or on the basis of efforts to keep their macroeconomic house in order. Evaluation of programmes is rather pointless if it is inconsequential.

### 5.3. Aid to third countries

The recommendations formulated so far on the budgetary consequences of 'economic union' policies amount largely to incremental changes. In contrast, the case for assigning a more important role to the Community level of government, argued in Section 4.1.1, along with the widely felt need — partly based on economic self-interest — for the Twelve to step up their assistance to the rest of the world, militate in favour of a quantum jump in the external tier of Community expenditure. A strong expansion of the foreign aid envelope would permit the Community to grow into a key donor on the world scene, which would be instrumental in shaping the nascent common foreign policy, the legal basis of which will be reinforced with the Treaty on European Union.

As can be seen from Table 22, Community aid to third countries equals some ECU 6 billion in 1993 or 0,18% of EC GDP. It consists of outlays contained in the EC budget proper and of the European Development Fund, which is fed through direct national contributions and serves to finance the EC's commitment in the framework of the Lomé Conventions with the ACP countries.<sup>3</sup>

**Table 22**

**EC aid to third countries in 1993 (grant commitments)**

	Million ECU	% of EC GDP <sup>1</sup>
1. EC budget intervention	4 110	0,120
of which to LDCs	2 537	0,074
of which to Eastern Europe and ex-Soviet Union	1 573	0,046
2. Reserves	209	0,006
3. EDF	1 900	0,055
1 + 2 + 3	6 219	0,18

<sup>1</sup> Including the former East Germany.

Source: Commission services.

With the collapse of the communist regimes, a rapidly increasing share of total assistance (currently about 25%) goes to Eastern Europe and the former Soviet Union. Table 23

<sup>1</sup> See Gordon (1991), pp. 19 and 20.

<sup>2</sup> In this context, the link in the framework of the Cohesion Fund between Community transfers and recipient Member States' undertakings to achieve a better 'convergence' performance with regard to public finance in preparation of their accession to the final stage of EMU is to be welcomed.

<sup>3</sup> There are no clear economic reasons why the EDF is kept outside the ordinary budget; this anomaly should thus be rectified.

shows that as far as development cooperation with the Third World is concerned, the Community accounts only for around 10% of aid by the Twelve. This contrasts with the prominent role taken by the Community level of government with regard to economic support to the East where the need for speedy action and a unified stance, in conjunction with the attribution by G7 of the task to coordinate donors' initiatives, pushed the Community to the fore. As indicated in Table 24, roughly one third of total EC grants to Eastern Europe is provided through Community channels.

Adopting a number of plausible working hypotheses, one can map out the budgetary upshot of the desirable larger role of the Community in development assistance.

As regards aid to LDCs, it would appear acceptable to assume that over time the Community as a whole would respect the UN norm of 0,7% of donors' GDP, given that the economic predicament of many Third World countries shows little sign of abating. Currently, its efforts, which compare favourably to those of the US or Japan, stand at 0,48% of GDP (see Table 23). If the remaining gap were closed by raising the Community's development assistance — such that the ratio of supranational to national aid evolved from the present one eighth to more than one half — the EC budget would have to grow by 0,22% of EC GDP, or about ECU 12 billion per annum at 1992 prices.

Because the situation is not yet sufficiently stable and transparent for a reliable, comprehensive, 'bottom-up' assessment of capital needs, a parallel is often drawn in the discussion on aid to Eastern Europe and the former Soviet Union with the assistance provided by the USA to Western Europe under the Marshall Plan. As it is perceived to have been an important catalyst in the process of post-war recovery, the latter has positive connotations with Community public opinion, which should render an analogous intervention for the former communist countries politically more palatable. Although one should guard against too simplistic assess-

**Table 23****National and Community aid to LDCs, 1992**

	Million ECU	% of GDP <sup>2</sup>
1. Member States <sup>1</sup> official development assistance	20 979	0,43
2. EC	2 529	0,057
1 + 2	22 508	0,48
USA	8 979	0,20
Japan	8 589	0,30

<sup>1</sup> Excluding Greece.

<sup>2</sup> Excluding the former East Germany.

Source: OECD Development Assistance Committee.

**Table 24****Distribution of assistance committed to the countries of Central and Eastern Europe from the first quarter of 1990 to the fourth quarter of 1992 inclusive**

	(Million ECU)								
	Economic restructuring assistance (projects)	Macro financial assistance	Emergency assistance	Official export credits	Official support for private investment	Other	Total	In form of grants	% of total in form of grants
EC Member States total	2 554,45	3 747,08	454,81	5 834,14	1 373,26	448,32	14 412,07	4 635,57	32,2
EC	1 749,50	2 500,00	644,80	81,00	25,00	25,85	5 026,15	2 463,65	49,0
EIB	887,00	—	—	—	—	2 553,00	3 440,00	—	0
ECSC	25,00	—	—	—	—	1 750,00	200,00	—	0
Community total	5 215,95	6 247,08	1 099,61	5 915,14	1 398,26	3 202,17	23 078,22	7 099,22	30,8
Japan	786,51	1 175,08	26,19	543,50	0,78	0	2 532,06	556,26	22,0
USA	397,01	2 280,10	364,19	1 859,23	285,87	359,88	5 546,28	3 581,75	64,6
G24 total	7 354,97	12 381,38	1 631,98	10 428,76	1 975,60	4 014,16	37 786,82	14 146,28	37,4

Source: Commission services.

ments of the effect of the Marshall Plan,<sup>1</sup> it is useful to pursue this parallel in some depth and advance a rough estimate of the ensuing budgetary implications.<sup>2</sup>

Collins and Rodrik (1991) calculated Marshall-Plan-based estimates of aid to Eastern Europe and the former Soviet Union. The various alternatives they present are reported in Table 25.

**Table 25**

**Marshall-Plan-based estimates of aid for Eastern Europe and the former Soviet Union**

Alternative method	Eastern Europe (1)	Soviet Union (2)	Total (3)	Total over whole period (4 x (3))
Real per capita adjustment	4,8	11,9	16,7	66,8
2% of recipient GDP	14,0	34,0	48,0	192
1% of donor (OECD) GNP			136,0	544

NB: First three columns refer to billions of dollars per year.

Source: Collins and Rodrik (1991).

The Marshall Plan transferred over a four-year period (1948-51) USD 12,4 billion to 16 Western European countries, mostly in the form of grants. There are several possible ways to update this transfer to the current situation. The first listed, translating into USD 66,8 billion at 1989 prices, ensures the constancy of real per capita support. The other two methods relate to GNP as the basis for scaling. The Marshall Plan transfer amounted to around 2% of the recipient countries' combined GNP per annum over the four years. Collins and Rodrik 'guestimate' 2% of Eastern European and former Soviet GNP to equal USD 48 billion. Finally, the annual average of the transfer was equivalent

to about 1% of the then US GNP. One per cent of the 1989 GDP of the OECD (G24) amounts to some 136 billion, signifying a global envelope of USD 544 billion, according to this updating method.

Whilst the eventual volume of aid from the OECD countries, its distribution among donors and its time-spread, will depend on a host of political and economic factors which cannot be anticipated fully, the Collins and Rodrik data give a fair picture of the potential impact on the EC budget. Taking the average of the three alternative methods and assuming, on grounds of geographical proximity and cultural kinship, the Community were prepared to put up half of the G24 effort, aggregate transfers from the Twelve would amount to some ECU 130 billion at 1991 prices. If the current distribution of aid to Eastern Europe between the Community and the Member States were maintained, an assistance 'stock' of nearly 100 billion would need to be dispensed through the Community budget. Given that the deployment of a functioning market economy is proving more complex and time-consuming than expected, it would appear advisable to spread the Community's 'Marshall aid' over a longer period, perhaps extending to a decade.

Under those assumptions, aid to Eastern Europe and the former Soviet Union would occasion another ECU 10 billion per annum growth (0,2% of GDP) of the EC budget.

#### 5.4. Summary picture of global budgetary implications

This chapter has sought to offer a rough quantitative appraisal of the budgetary impact which the desirable development of supranational competences in the perspective of EMU and the EC's strengthened external role is liable to entail. By way of conclusion, the various expenditure categories that have been reviewed are assembled in Table 26 so as to arrive at a picture of the appropriate total size of the EC budget at the start of the following century.

As most of the underlying estimates are approximate, the magnitude of some budgetary items is as much, if not more, governed by political as by economic considerations, and the long-term growth rate of the denominator, EC GDP, is hard to predict, this table must obviously be seen as indicative, which explains why in some cases ranges are employed.

<sup>1</sup> The actual role the Marshall Plan played in reviving economic growth is not clear: see Eichengreen and Uzan (1992). Moreover, the aid was not tied to investment, but served primarily to meet the 'dollar shortage' problem and facilitate external debt redemption.

<sup>2</sup> The launching of a Marshall-type plan could go hand in hand with the setting up of a 'payments union' among the beneficiary countries to stimulate trade.

**Table 26****Desirable aggregate volume of EC expenditure in the fields of allocation and redistribution at start of the final stage of EMU<sup>1</sup>**

Expenditure categories	Indicative % of EC GDP	% share	% share in 1992 budget <sup>2</sup>
CAP	0,4-0,5	26	56
R&D, environment, trans-European networks	0,15-0,2	11	5
Structural Funds (including Cohesion Fund)	0,4-0,5	26	27
Aid to LDCs (including EDF)	0,3	30	6
Aid to Eastern and Central Europe	0,2-0,25		
Other	0,1	6	6
Total	1,55-1,9	100	100

<sup>1</sup> On present outlook, 1999 and thereafter.<sup>2</sup> Figures differ from those given in Table 3 because of inclusion of the European Development Fund.





## Chapter 6

### Stabilization support

It was argued in Section 4.2 that the move from a narrow band 'EMS + 1992' to EMU will not modify profoundly, at least not *de facto*, individual Member States' capacity to conduct stabilization policies with a view to offsetting minor deviations from trend output and employment growth. This ought not, however, to be interpreted as meaning that Member States should be left entirely to their own devices in adjusting to shocks. More specifically, it was argued that in the face of serious, country-specific, negative disturbances, a Community assistance instrument should be created to compensate for the loss of the exchange-rate realignment possibility.

The traditional 'automatic stabilizers' in mature federations and unitary countries were judged inappropriate as a model for the Community on a number of grounds. First, they are rather inefficient in that the stabilization impact they engender is the outcome of massive financial flows through the central tax and social security systems, typically involving tens of percents of GDP. Second, their prime objective is to provide for interpersonal, hence interregional, income redistribution, and not to ensure regional stabilization support. Finally, the operation of a Community-wide social security system, or parts thereof, such as a European unemployment scheme, would face tremendous microeconomic and managerial difficulties. It was therefore concluded that in seeking to assist Member States in their efforts to stabilize their economy upon the advent of shocks, the Community should tread new paths and devise a mutual insurance instrument generating country-specific stabilization in an efficient and thereby inexpensive way.

The purpose of this chapter is to explore in some depth a practical proposal for such a mutual insurance scheme and its costs, based mainly on Italianer and Vanheukelen (1993), which takes the previous decade as a benchmark. In order to keep in mind the correct theoretical perspective, the desirable properties of a stabilization instrument are recapitulated first.

#### 6.1. Normative characteristics of a regional stabilization instrument

As pointed out in Goodhart and Smith (1993), for a stabilization instrument to be pure and effective, it needs to respect the following three general principles:

- (i) The instrument should be triggered following changes in economic activity but its intervention should be halted as soon as no further changes occur, irrespective of the level at which the economy has again become stable. Otherwise, the instrument would perform not only a stabilization function, but also play a redistributive role. Such an 'impurity' is typical for traditional fiscal policy measures, but should be avoided in the Community context as it may perpetuate adjustment problems and induce transfer dependency.
- (ii) The instrument should make its impact during the decline in real economic activity, and not afterwards, when the economy has stabilized or is already recovering. If the intervention affects the economy too late, undesirable fluctuations around trend growth will be amplified by government action. As stressed in Friedman (1953), timing is critical to the success of stabilization policy, as well as hard to get right because downturns can be sharp yet relatively short-lived and any discretionary instrument is subject to the problem of recognition and policy implementation lags which can easily amount to more than half a year. Given the need for speed, the activation of the instrument should therefore be preferably linked to an indicator, whose fluctuations form a close proxy for variations in real output, and whose measurement is accurate and quick.
- (iii) Stabilization is usually seen as arising through the effect of public financial transfers on private agents' incomes, and hence consumption. Ideally, a Community stabilization instrument should therefore, directly or indirectly, make a significant contribution on the margin to the income of individuals in the Member State(s) going through a recession.

#### *Community-specific principles*

On top of these requirements, a Community instrument to assist regional stabilization should reflect two additional considerations.

First, the instrument should only provide support inasmuch as the registered economic decline displays a clear country-specific dimension. As argued in Section 4.2, shocks affecting the whole of the Community should be responded to by fiscal policy coordination among the Twelve, the automatic stabilizers at national level, and, if the aim of price stability permits, the exchange rate and monetary policy stance of the ESCB. Only when a country's slump distances it from the rest can EC assistance be forthcoming.

Second, in keeping with the reasoning that the abandonment of the exchange-rate instrument should be compensated for and recognizing that devaluation is not resorted to for each and every dip of real activity below trend, Community help should act as an insurance against grave economic difficulties. Accordingly, support should take place only in the event of major negative developments. The shock may be of a regional or sectoral nature but it should have clearly measurable significant macroeconomic repercussions. Moreover, in view of the objective of stabilization, neither the relative magnitude nor the likelihood of support should in any way be influenced by the relative prosperity of Member States. Each Member State should stand, in principle, an equal chance of being eligible for Community assistance.

As a final general remark, regional stabilization support should preferably take the form of Community grants rather than loans. For one thing, Community loans are scarcely appealing for Member States enjoying a strong credit rating on international capital markets. For another, Member States which, in EMU, need to offer a significant interest premium will in all likelihood be characterized by a high debt-to-GDP ratio. Community loans will raise the country's level of indebtedness, pushing it further into the 'excessive deficit' zone. Loans may thereby undermine the credibility of the latter concept, which is central to the Community's strategy in EMU to combat the public finance sources of inflation. Conversely, the existence of Community stabilization support would facilitate Member States' observance of the 'excessive deficit' constraint by tiding over economic downswings.

## 6.2. Design of a financial assistance mechanism

Against this backdrop, the present section maps out the possible concrete functioning of a Community financial mechanism for regional stabilization.

### *Measurement*

A first important issue to be addressed concerns the measurement of changes in real activity. Data on GDP are, at best, available on a quarterly basis and subject to considerable errors, especially initially, which would be when the mechanism should be activated. Partial indicators of real activity that are sometimes mooted in the literature for this purpose, like electricity or energy consumption or telephone usage, are defective because of random seasonal factors or problems of international comparability, even in terms of rates of change resulting from the modernizing of industry or the catch-up in living standards. Italianer and Vanheukelen (1993) use the survey data on unemployment collected by

the EC Statistical Office, which have the advantage of being available within a few months and possess a high degree of uniformity.<sup>1</sup> A rough idea of the development of real activity may then be obtained by way of the parameter estimates of a so-called 'Okun's Law' equation, relating changes in the unemployment rate to deviations of GDP from trend growth. In any case, given its central role, the indicator of real economic activity should be chosen with great care, perhaps even be devised from scratch, so as to conform well with the needs of accuracy, speed of availability, and international comparability.

### *Application*

The financial assistance mechanism would be based on a monitoring of the monthly year-on-year changes of a Member State's indicator relative to the Community average (excluding the Member State itself). If the indicator pointed to a fall of real activity below trend which was significantly worse than the performance of the weighted average of the 11 other countries, the Member State in question, in principle, would be eligible for support under the mechanism.

The design of the mechanism necessitates answers to three further questions: whether its activation should be triggered automatically or on a discretionary basis; how to interpret in operational terms a 'significant' deviation from EC average; and, finally, whether the ultimate destination of the Community transfer within recipient countries should be specified.

This report so far has come out strongly in favour of subjecting Community transfers to clear conditions. A similar view could be taken here. For the sake of its credibility, the mechanism should be protected against accusations that it would amount to a disguised bail-out channel for undisciplined national governments. One could thus require the potential beneficiary country to provide evidence that the problem at hand was of an 'exogenous' nature, i.e. resulting from shocks whose origin could be reasonably considered to lie beyond past and present domestic governments' responsibility. By the same token, one could advocate attaching national policy conditions to disbursements under the mechanism, pursuant to the notion that a devaluation — which the mechanism is meant to substitute for — can only produce satisfactory effects if it is accompanied by structural measures.

<sup>1</sup> Unemployment is often argued to be a lagged indicator of the evolution of real activity on account of phenomena such as labour hoarding, thereby perhaps exhibiting a pro-cyclical profile. This alleged characteristic does not, however, seem to be borne out econometrically. See Italianer and Vanheukelen (1993).

Nevertheless, there are also powerful arguments militating in favour of automaticity, which, on balance, would seem to prevail.

First of all, activation predicated on a discretionary judgment of the Community authorities is inevitably time-consuming and may therefore be at variance with the crucial requirement of prompt intervention. Second, moral hazard problems, often connected with unconditional support, appear rather small under the proposed mechanism. Whilst the necessary should be done to make the indicator foolproof, the incentive to try to manipulate it or to deliberately effectuate a decline in national economic activity is weak. On the one hand, a one-time deterioration of the indicator will only lead to a one-time transfer, since the mechanism is built on changes in the indicator. On the other, 'engineered' changes in the national indicator may well be frustrated by the evolution elsewhere in the Community: a worsening of the economic situation in a Member State which is paralleled by negative developments in the rest of the Community will not give rise to a transfer under the financial assistance mechanism.

Moral hazard problems will be further reduced by establishing a threshold below which a decrease in real economic activity relative to the EC average would not be compensated. Setting a minimum norm for deviations also would be in line with common insurance practice according to which minor damages are not covered. The precise fixing of the threshold would, of course, be a matter of political judgment and would depend on how ambitious and costly one would wish this financial mechanism to be. *Ceteris paribus*, the lower the threshold, the more frequently will the mechanism be activated and the larger will be the associated budgetary outlays.

As to the third question, the support under the mechanism is to take the form of a block grant from the Community to the government concerned. However, such a grant will not exert any stabilization influence in its own right as it does not impinge on private agents' expected income in the immediate future. It therefore would be desirable to explore feasible ways to pass on the grants as quickly as possible to households. Community guidelines could be elaborated to this end, but, in the light of subsidiarity, it would seem wise to leave it to the individual Member States how to put the transfer to best use.

### 6.3. Costing and financing

The budgetary cost of the proposed financial assistance mechanism would, obviously, be a function of its generosity.

More specifically, it would be contingent on the existence of a threshold, the size of the transfer per 'unit' of deviation from the Community average, and on whether or not a ceiling is set on the annual volume of support a Member State possibly can receive. The choice with respect to these three parameters, in conjunction with the selected method of measuring 'shocks', then determines the mechanism's stabilization power.<sup>1</sup>

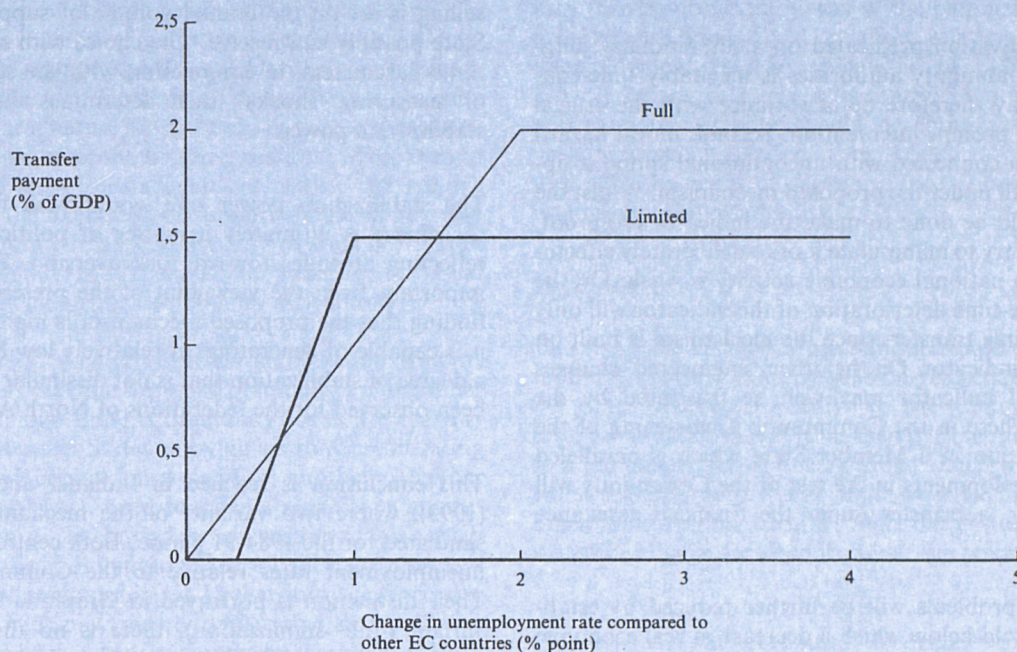
The stabilization power one would wish the mechanism to achieve is ultimately a matter of political preferences, reflecting attitudes towards risk aversion. However, more important from the viewpoint of the present report is the finding that the proposed mechanism is highly efficient, i.e. it is capable of generating, at relatively low budgetary cost, a degree of stabilization that is not dissimilar from what has been observed for the federations of North America.

This conclusion is reached in Italianer and Vanheukelen (1993), where two variants of the mechanism have been simulated for the 1984-91 period. Both centre on changes in unemployment rates relative to the Community average. Their distinction is portrayed in Graph 4. Under the first variant ('full' stabilization), there is no threshold. Every percentage point difference in the monthly year-on-year increase in unemployment *vis-à-vis* the Community average (excluding the country concerned) gives rise to a monthly payment of 1% of one twelfth of the previous year's GDP of the Member State concerned. Relative unemployment increases above 2 percentage points receive no additional compensation. As a corollary, the maximum monthly payment to a country is equal to 2% of one twelfth of its annual GDP. The other variant ('limited' stabilization) contains a threshold at 0,3% relative unemployment change, is twice as generous at the margin, with a transfer 'slope' of 2% rather than 1% (see Graph 4), and is truncated at a payment of 1,5% instead of 2%, implying that the part of any deviation in excess of 1,5 percentage points does not receive support.

Evidently, the choice of parameter values is largely arbitrary, which is why these simulations should be seen as purely illustrative.

<sup>1</sup> The magnitude of a country-specific shock can be conceived of in absolute terms, or in terms of the difference from the shock experienced by the average of the 11 other Member States. In Italianer and Vanheukelen (1993) the latter measurement has been opted for, on the ground that the aim of a Community stabilization instrument is to offer relief for the country-specific portion of the shock.

GRAPH 4: Transfer payments with full and limited stabilization scheme



However, as shown in Graph 5, both variants are capable of engendering a significant degree of stabilization.<sup>1</sup> During the sample period, it amounted for each of them to around 18 to 19% on average, which compares well with the 17 to 28% and 17 to 24% range reported in the literature (see Table 9) for the USA and Canada respectively. In both cases, this stabilization offset is generated inexpensively, with an annual average cost of about ECU 10 to 11 billion at 1990 prices, or slightly more than 0,2% of EC GDP. The basic reason for this high level of efficiency is that, unlike the 'automatic stabilizers' in existing federations, the proposed mechanism is explicitly designed for regional stabilization purposes, rather than being a by-product of redistributing programmes.

Focusing on the second variant, Table 27 indicates, by Member State, the times at which the mechanism would

have been activated, as well as the transfer sums involved.<sup>2</sup> For example, in 1991, the UK and Ireland would have qualified during the entire year, and Denmark in the first four months. Over the sample period, the mechanism would have intervened during 210 out of 1 034 months, or in some 20% of possible cases. The last column shows that, equalling 0,22% of EC GDP on average, the burden for the Community budget would have peaked in 1984 at close to 0,4%, reaching a low in 1990 at 0,07%.

#### *Budgetary form and financing*

As it is designed to respond to often unforeseeable economic developments, the mechanism's budgetary shape should be

<sup>1</sup> The degree of stabilization is non-linear on account of the existence of a maximum level of entitlements, along with the presence of a threshold in the case of the 'limited' variant.

<sup>2</sup> Monthly unemployment data are not available for Greece. Repeating the analysis with annual data demonstrates that the inclusion of Greece in the mechanism does not alter average annual budgetary costs in terms of GDP in any substantial way.



GRAPH 5: Degree of stabilization with full and limited stabilization scheme

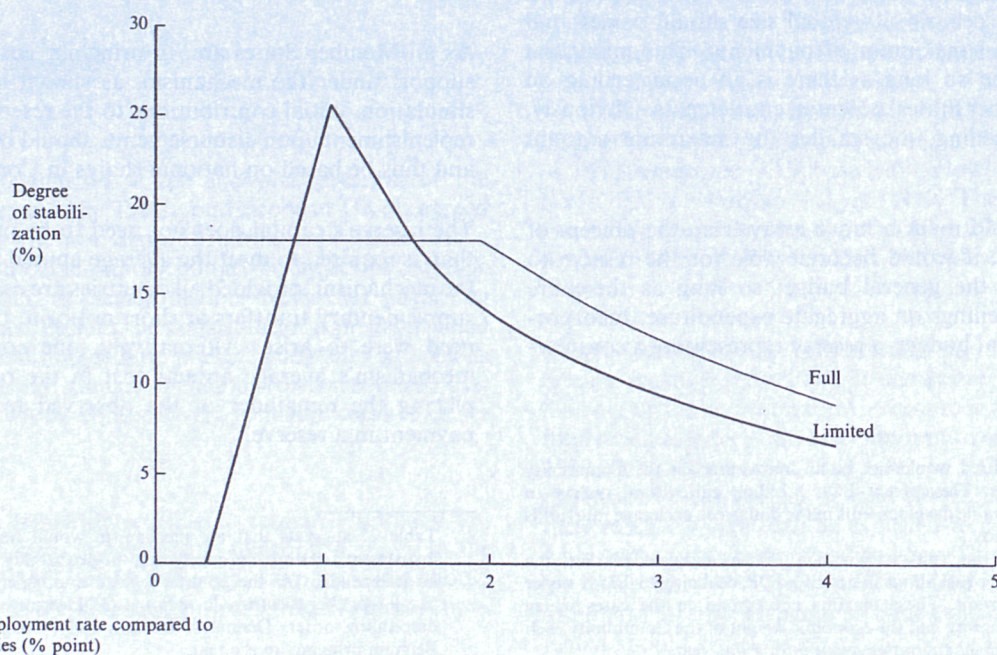


Table 27

Limited stabilization scheme using monthly data (months of activation and amount of payments)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EUR 11	Total billion ECU (1990)	% GDP
1984	—	—	—	:	1-12	1-12	1-12	—	—	1-3	1	—	40	18,576	0,384
1985	—	—	—	:	1-9	1-4	1-12	9-12	—	—	—	5	30	8,728	0,180
1986	11	—	—	:	—	10-12	1	1-12	—	—	—	9	18	12,030	0,248
1987	—	4-12	11-12	:	—	1-9	—	1-3	4+6-12	—	—	—	31	7,741	0,160
1988	—	1-12	1+5	:	—	—	—	3-12	—	—	—	—	24	13,990	0,289
1989	—	1-12	—	:	—	—	—	1-7	—	—	—	—	19	9,061	0,187
1990	—	1-12	—	:	—	—	11+12	—	1+2	—	—	9-12	20	3,466	0,072
1991	—	1-4	—	:	—	—	1-12	—	—	—	—	1-12	28	10,268	0,212
Months	1	49	4	:	21	28	39	36	10	3	1	18	210		
January 1984 to October 1991:															
Total (billion ECU (1990))	0,010	4,569	4,046	:	9,698	18,914	1,298	32,823	0,031	0,275	0,059	12,138		83,860	
% GDP	0,007	4,429	0,321	:	2,506	2,018	3,881	3,822	0,448	0,125	0,125	1,549			1,731
Annual average (billion ECU (1990))	0,001	0,583	0,517	:	1,238	2,415	0,166	4,190	0,004	0,035	0,008	1,549		10,706	
% GDP	0,001	0,565	0,041	:	0,320	0,258	0,495	0,488	0,057	0,016	0,016	0,198			0,221

that of a reserve.<sup>1</sup> In order for this reserve to respect the prohibition on incurring deficits in the EC budget at the same time as being in a position to honour all commitments in a worst-case scenario, its global size should correspond to the theoretical maximum of payments. This maximum can be calculated so long as there is an upper ceiling on individual Member States' potential entitlements. Obviously, the lower the ceiling, the smaller the maximum amount payable.<sup>2</sup>

Although it would mark a move away from the precept of budgetary unity, it would be preferable for the reserve to operate outside the general budget so long as there are predetermined ceilings on aggregate expenditure. Incorporated in the general budget, a reserve representing a consider-

able share of the volume of ordinary outlays, would seriously constrain the budgetary room for manoeuvre with regard to other Community responsibilities.

As all Member States are, in principle, equally eligible for support under the mechanism, as shown by the historical simulation, initial contributions to the reserve, as well as its replenishment upon disbursements, should be fiscally neutral and thus be based on national shares in Community GDP.<sup>3</sup>

The reserve's capital does not need to be paid up for more than is required to meet the average annual payments under the mechanism, provided all countries are capable of making supplementary transfers at short notice to the reserve if the need were to arise. Alternatively, one could include the mechanism's average annual cost in the ordinary budget, placing the remainder of the observed maximum annual payment in a reserve.

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<sup>1</sup> A contingency fund would not be an innovation for the Community budget structure. The current ECU 1 billion agricultural reserve to absorb unfavourable developments in the dollar/ecu exchange rate fulfils such a role already.

<sup>2</sup> In the case of the 'full' stabilization variant discussed earlier, the maximum would equal about 1% of EC GDP, declining to 0.75% under the 'limited' variant. These maxima correspond to the cases where countries representing half the economic weight of the Community each would receive the maximum payment during one year.

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<sup>3</sup> Table 27 suggests that the mechanism would respect a stabilization instrument's desirable property that the probability of receiving support be independent of the country's relative prosperity per capita. The five largest beneficiaries, in national GDP terms, would have been, in descending order, Denmark, Ireland, Italy, Spain and France, with Belgium bringing up the rear.

## Chapter 7

### Own resources

The right to levy taxes is the exclusive preserve of the Member States, and the Treaty on European Union agreed at Maastricht will not depart from this principle. As a consequence, the Community budget is subject to a public finance logic that is clearly distinct from that governing national budgets. Besides the constraint of a predetermined aggregate expenditure ceiling, present budgetary provisions define the different sources of finance (own resources) that need to be drawn on consecutively to match total revenues and outlays.

Assuming this regulatory regime to remain essentially unaltered, this chapter addresses the question of how, in the perspective of EMU, the Community's own resources should evolve as regards their composition and relative importance.

Taxes fundamentally perform two distinct economic functions. On the one hand, they generate revenue covering the public sector's expenditure needs. On the other, they can act as instruments to further economic efficiency, stability or equity objectives.

Although in practice most taxes serve a mixture of both aspects, the revenue and instrumental dimensions are separable and can in a context of multi-layer government be assigned to different levels of government. This is borne out by the stylized fact, documented in Section 3.2, that in federations tax competences are typically more centralized than expenditure competences. This separability also allows the revenue needs of one level of government to be met by grants from another.

The Community budget was financed in the main by national contributions during the initial stages of integration. This historical trait, in conjunction with the absence of own tax powers at the supranational level, explains why the debate on the financing of the Community budget has hitherto been strongly dominated by pure revenue arguments. However, as the move to EMU proceeds and the Community becomes more federal in nature, there are sound economic and political grounds why Community revenue should start reflecting more closely and systematically basic concerns of economic efficiency and fairness.

#### 7.1. Main features of current own resources

It will be recalled from Chapter 2 that, following the 1988 agreement on the first 'Delors package',<sup>1</sup> the Community is entitled to the integral revenue from the so-called traditional own resources, to a levy of maximum 1,4% on a harmonized VAT base and, finally, to national contributions on the basis of GNP to make budgetary ends meet. The maximum rate on the harmonized VAT base will be lowered in equal steps from 1995 onward to 1% in 1999. The traditional own resources consist principally of customs duties, the remainder being generated by agricultural levies and sugar contributions.<sup>2</sup>

Graph 6 portrays the evolution of the structure of Community revenue since 1971. It shows the steady decline of the role of the traditional own resources as a percentage of total revenue, which currently amount to somewhat less than 25%, down from more than 60% in 1977. With a further expansion of the budget beyond the 1,2% of GDP ceiling, their relative weight can be expected to continue to decline with unchanged commercial policies. This trend is likely to be reinforced by the prospective tariff concessions in the aftermath of the Uruguay Round and the CAP reform, which should boost prices on world agricultural markets.<sup>3</sup> Graph 6 also shows the buffer function of the GNP resource. The latter had not been resorted to up to 1990 by virtue of higher than expected economic growth. However, the most recent increments in EC expenditure could no longer be covered by the first three own resources. As a result, the GNP resource financed 13% of the budget in 1991 and 1992 climbing, on current forecasts, to over 20% in 1993.

About half of Community revenue comes from the so-called VAT resource. The latter term is largely a misnomer, because in spite of the original idea back in the early 1970s to confer to the Community an indirect tax shared with Member States, a goal which played a valuable role in the harmonization of national VAT bases, the link between this resource and the taxpaying consumers of the Community is very tenuous. The VAT resource is collected from the Member States by means of a notional harmonized base, and not as part of the VAT paid on each purchase. It is therefore

<sup>1</sup> As formalized in the Council Decision of 24 June 1988 (1988/376/EEC).  
<sup>2</sup> Levies on agricultural imports take the form of equalizing tariffs in the framework of the CAP. Their proceeds are strongly influenced by exchange-rate fluctuations and world market prices. Sugar contributions arise from the need to fund the costs of storage and export restitutions under the sugar scheme.

<sup>3</sup> According to the survey of the literature by Goldstein and Khan (1985) long-term price elasticities of import demand for industrial countries lie in the -0,5 to -1,0 range.



tantamount to a national contribution calculated following an accounting definition of the VAT base.<sup>1</sup> The latter is relatively larger in countries with a high consumption ratio, which tend to be the poorer Member States, as can be seen from column 1 in Table 28, expressing the notional VAT base for 1991 as a percentage of national GNP. In order to redress this imbalance, it was decided in the 1988 agreement to cap any country's notional VAT base at 55% of its GNP (column 2 of Table 28). This severs the indirect tax link altogether in the case of five countries, as capping implies a shift from VAT to GNP. It was decided at the Edinburgh summit of December 1992 to take a further step in the same direction.

Community revenue can therefore increasingly be said to result from customs duties, agricultural levies, and two types

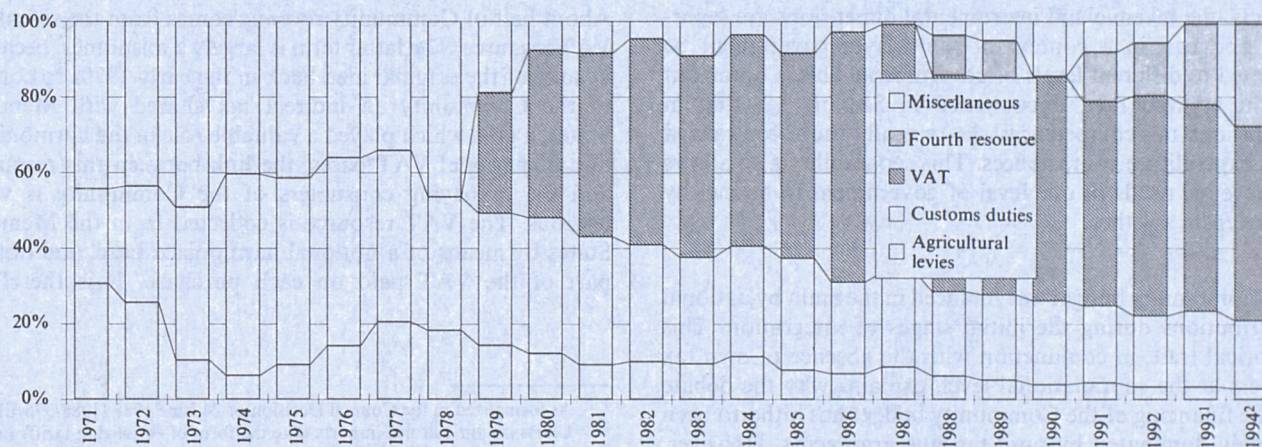
of 'block grants', i.e. national contributions, from Member States, one of which is of a hybrid nature.

A salient feature of the current revenue regime is that it has a specific set of rules for one Member State. After intense political debates on the net British contribution to the budget, an 'abatement' settlement was reached in 1984 and renewed in both 1988 and at Edinburgh, so hence it will remain effective until 2000. Although its source is primarily on the expenditure side, the British budgetary problem is alleviated by providing for a cut in the UK's VAT contributions amounting to two thirds of the difference between its share of VAT payments and its percentage share in EC expenditure.<sup>2</sup> This agreement has given rise to a supplementary country-specific deal in that Germany's share in the correction of the UK position has been restricted.

<sup>1</sup> This definition is not devoid of anomalies, as exemplified by the abnormally low figure for Italy as reported in Table 28.

<sup>2</sup> The UK abatement procedure heightens the complexity of the VAT resource further.

GRAPH 6: General budget, revenue sources from 1971 to 1994



<sup>1</sup> 1993 budget.

<sup>2</sup> 1994 preliminary draft budget.

**Table 28**

VAT bases as a percentage of GNP (data relating to 1991)

	Uncapped	Capped
Belgium	46,6	46,6
Denmark	42,8	42,8
Germany	48,6	48,6
Greece	56,5	55,0
Spain	52,3	52,3
France	52,6	52,6
Ireland	67,2	55,0
Italy	40,6	40,6
Luxembourg	66,0	55,0
Netherlands	50,3	50,3
Portugal	67,6	55,0
United Kingdom	60,8	55,0
EUR 12	50,5	49,3

## 7.2. Securing proportionality in the run-up to EMU

Notwithstanding the wish of a number of Member States to introduce a fifth resource, it was decided at Edinburgh to leave the current composition of the EC's own resources unaltered for the period to 1999, and to ask the Commission in the intervening period to conduct an in-depth analysis of other possible resources. This decision is appropriate as long as full monetary union has not been achieved and the *acquis communautaire* as regards taxation remains unchanged, since the EC will not be in a position to use other own-resource candidates which are identified later in Section 7.3.

An unavoidable issue in a system where supranational revenues are collected through the national administrations or generated by direct national contributions, such that funding flows are easily traceable, is whether the sharing of the burden exhibits basic fairness. A minimum notion of fairness is proportionality, i.e. that a country's share in Community revenue be equal to its prosperity per capita.

### *The case for proportionality*

It is the opinion of the expert group that the main objective on the revenue side to be pursued prior to the final phase of EMU is the achievement of proportionality for each and every Member State, implying the removal of existing country-specific arrangements. However, so long as the Community does not move more clearly in the direction of social and political union than it is poised to do after the coming into force of the Treaty on European Union, the

quest for revenue fairness should not be carried further than that. From this normative perspective, the Edinburgh decision to shrink the role of the VAT-based own resource should be judged positively, whereas the continuation of the specific regime in favour of the UK cannot be upheld.

The case for proportionality rests on a dual argument. First, redistribution by way of advantageous revenue arrangements has the same effect as unconditional block grants. It was argued in Chapter 5 that at the present stage of integration unconditional aid is by no means the most appropriate instrument. Redistribution at the supranational level should desirably operate at the spending side through expenditure-related or, preferably, performance-related inter-governmental grants. The validity of this reasoning is corroborated in the case of the British budgetary problem which is primarily associated with the national distribution of EC outlays arising from the CAP.

Secondly, it should be noted that the issue of public finance fairness can eventually be approached in a sensible way only by a simultaneous assessment of the two sides of the budget; from this perspective, proportionality at the revenue side would be a good position to start from.

### *Implementation issues*

The pursuit of proportionality raises several questions of implementation. To start with, there is the issue of how to measure prosperity. A first choice needs to be made between gross domestic product and gross national product, which differ because of net factor payments (interest, dividends, and labour income) from abroad. As the concern here is about equity and therefore disposable income, GNP should be opted for. Second, there is the question of comparing national GNPs in simple money terms or on the basis of purchasing power standards (PPS). The income disparity between Member States is typically smaller in PPS on account of the higher price level in richer countries for non-tradable goods and services, like housing. In principle, PPS forms a superior yardstick in a context of equity. However, expressing GNP in PPS involves complex calculations of conversion rates on which there is in practice no methodological consensus. To minimize political friction, it would appear advisable to stick to GNP expressed in ecus, bearing in mind, though, that a tax arrangement delivering proportionality in ecu terms is likely to have a progressive incidence in economic reality. Third, the measurement of prosperity depends on the production by Member States' administrations of national accounts. This may be a serious source of distortions as countries characterized by an important volume of unreported economic activity underestimate their actual level of income. Finally, and although

various initiatives are under way to make up for this loss of information, there may arise a GNP (and GDP) measurement problem following the elimination of border controls, upon which the collection of trade statistics have partly relied until now. If national GNP figures were to grow seriously inaccurate, one would have to look for a new statistical indicator of prosperity.<sup>1</sup>

The simplest and most transparent fashion to achieve overall proportionality would be to abolish the VAT resource and replace it with an increased reliance on national contributions on the basis of GNP. Apart from guaranteeing proportionality, a further consideration for dropping the VAT resource is that it has outlived its role of promoting VAT-base harmonization among the Member States. Moreover, as will be argued in Section 7.3.1, even if Community revenue were directly related to actual tax payments by consumers, VAT would not seem on economic grounds to form the best candidate as an own resource.

Short of an outright abolition of the third resource, proportionality could be ensured by a further capping of the VAT base, a reduction of the present 1.4% call-up rate, or by attaching a 'proportionality ensuring' key to national GNP contributions. Capping the VAT base down to 40% would amount to a silent termination of the third resource and its *de facto* substitution by the fourth. The practical problem with the use of the GNP key to offset the regressivity of the VAT base would be that as the relative weights of the third and fourth resource shift every year, any key determined *ex ante* may turn out to actually over- or undershoot the neutrality objective, necessitating a further *ex post* correction procedure.<sup>2</sup>

In any event, as can be gauged from Table 29, the own resources decisions of Edinburgh will have gone a long way by 1999 towards the attainment of proportionality.

The first row of Table 29, traditional own resources (agricultural levies and customs duties), can basically be ignored in the proportionality discussion since (as will be argued in the next chapter) it is virtually impossible to apportion them by country in a meaningful way. Of the revenue from the two remaining resources (VAT and GNP), the GNP resource will amount to almost 58% in 1999. Moreover, the inequity of the VAT resource will have been mitigated by the reduction of the capping point to 50% of GNP.

**Table 29**

**The effects of the Edinburgh agreement on the shares of own resources in 1999**

	(%)	
	No change	Edinburgh agreement
Traditional own resources	17,72	17,72
VAT	52,14	34,38
GNP	30,14	47,90
Total	100	100

### 7.3. New own resources

From a strict revenue point of view, the Community would be able to rely completely on unconditional block grants from the Member States to cover the future rise in expenditure as mapped out in Chapters 5 and 6.

However, as the Community enters the final stage of monetary union and new tax initiatives in the pursuit of the economic union goal become necessary, it would be preferable for the EC to go beyond its current own resources and have direct access to other tax bases.

A situation in which the budget is overwhelmingly funded by national contributions is politically unsatisfactory in the longer term as it makes the Community's financial dependence on national governments very apparent. The EC budget threatens then to be much more a function of national budgetary priorities than the concern of the Community and its citizens. Because national contributions are not always perceived by Member State governments and parliaments as genuine EC own resources, there is great reluctance to raise the budget even if overall size constraints are respected.<sup>3</sup> This has been illustrated repeatedly since 1988 by the difficulty in obtaining the consent of the Council to expand EC spending notwithstanding the fact that proposed increases fell well short of the global ceiling on own resources. The view that over time Community public finance should rest more on individual economic agents rather than on Member States seems to be endorsed by a recent public opinion survey in which about 60% of respondents declared themselves in favour of EC taxes.<sup>4</sup>

<sup>1</sup> A possible candidate would be a country's measure of value-added for fiscal purposes, which would reinvigorate the role of VAT in EC revenue.

<sup>2</sup> Such a procedure would not be entirely new. At present, a country's fourth resource obligation in a given year is based on forecasts from April of the previous year and corrected *ex post* for forecast errors in October of the following year.

<sup>3</sup> In national budgetary rules and procedures, traditional own resources are often treated differently from the VAT or GNP resource.

<sup>4</sup> Eurobarometer survey, May 1991.

New own resources directly related to tax bases proper could, but need not necessarily, go hand in hand with the assignment to the EC level of government of the power to introduce Community taxes autonomously. The latter reform would clearly be politically more radical and would mark an important further step towards a 'federal' Europe, as a genuine EC tax would clearly call for greater European Parliament responsibility as regards both its level and its uses (see Section 11.4).

A useful starting point to tackle the question of new own resources is to review the theory of fiscal federalism relative to the vertical assignment of tax competences and to note any lessons that are derivable from the current practice in federal States.

### 7.3.1. Vertical tax assignment in theory and practice

The theory of fiscal federalism identifies essentially four distinct potential grounds for conferring tax powers to the central level of government. These grounds are associated respectively with economic, social, political and management considerations.

- (i) The economic rationale for centralizing tax competences can be subdivided in two aspects: on the one hand there is the case for central taxes as a response to cross-border tax externalities and as a 'federal' micro-economic instrument; on the other, there is the issue of handing over to the central level of government revenue from taxes whose base cannot be defined reasonably at the State level. This regional arbitrariness problem formed the main reason why, upon the establishment of the customs union, customs duties' proceeds were earmarked as EC revenue.

As to the first aspect, it will be recalled (see Section 4.1.2) that complete State autonomy over tax bases that are internationally mobile will tend to occasion too low levels of taxation than would otherwise be the case. Tax harmonization or approximation to correct for this externality requires at least that the tax base be (broadly) harmonized and a minimum rate observed.<sup>1</sup> The attribution to the central government of a share of revenue or its entitlement to a surcharge could strongly promote the attainment of the desired tax base harmoni-

zation or approximation. The economic argument for a federal tax appears very powerful in those cases where the instrumental dimension of taxes is stressed and the federal level is seen — for instance on internal market grounds — as the best level of government to steer economic agents' behaviour through changes in effective tax rates.

- (ii) Traditional welfare theory holds that economic agents be taxed in accordance with the advantages they derive from public goods and services provided below cost (the benefit-pricing principle), or, alternatively, according to their ability to pay. The latter criterion reflects a basic equity concern. Inasmuch as there is a desire to use the tax channel to reduce interregional primary income differentials or to operate a federation-wide interpersonal redistribution system, the central level of government needs to possess competences over taxes displaying a progressive incidence on regional and/or personal income.
- (iii) The power to introduce taxes and to determine the destination of their proceeds lies at the heart of sovereignty and representative government. The distribution of tax competences is therefore inevitably an eminently political issue as well, since it mirrors the relative legitimacy of the various layers of government. Greater fiscal autonomy tends to go hand in hand with stronger political influence.
- (iv) Lastly, the assignment of tax functions should also pay attention to the administrative aspects of tax collection. Centralization of taxes, or at least their collection, may permit economies of scale and offer a better guarantee for an equal treatment *de facto* of individual taxpayers regardless of where in the federation they happen to reside. This holds in particular for those tax categories where, due to the intricacies or ambiguities of the definition of the taxable base, there is a high degree of discretion in applying and enforcing uniform provisions.

These four politico-economic factors have all contributed to shaping the evolution and current state of the distribution of tax powers in existing mature federations. However, as their relative importance has unavoidably varied from country to country — for instance on account of the specific historical context,<sup>2</sup> divergent attitudes toward social equity

<sup>1</sup> A converse sort of externality, possibly calling for maximum rates, may arise when the price elasticity of export demand from other jurisdictions in the federation is low, which may for example be the case for some raw materials. Under such circumstances, the State in question may engage in 'tax exporting', allowing it to raise part of its revenue from taxes that are effectively paid by residents of other jurisdictions.

<sup>2</sup> For example, the Federal Republic of Germany, where the balance of powers between *Bund* and *Länder* could be built up from scratch in 1948, contrasts with the Swiss case where the distribution of competences is the outcome of a much more gradual process.

and differences in the degree of interdependence — the picture emerging from a comparison between federations is not clear-cut, as demonstrated by the observation that, barring a few notable exceptions, virtually every sort of tax is used by each sphere of government somewhere (Walsh (1993)).

The stylized facts from federal practice are therefore bound to be limited in number. Table 30 provides an overview on the distribution of powers, according to the terminology employed in Section 3.1.2, between the central and state levels of government for the main tax categories. It indicates that customs duties belong invariably to the exclusive competence of the federal government, whilst the latter is virtually absent in the domains of property, wealth and heritage taxes. No uniform pattern is discernible, however, with re-

spect to the categories that generate the lion's share of revenue, i.e. income and consumption taxes. In Australia and Germany, the role of the federal government is paramount, with states having no direct access to any of the tax bases involved (except for selective sales taxes in Australia). By contrast, states in North America and especially Switzerland enjoy a high degree of tax autonomy. This applies in particular to personal income and corporate taxes where neither the base nor the rates have been the object of any formal harmonization. In Canada, all provinces except Quebec have opted, on grounds of managerial convenience, for a shared personal income tax system where the provinces use the federal government's definition of the tax base and collection procedures. The diversity of arrangements is most pronounced in the indirect tax field, with exclusive competences sometimes being located at the federal (Switzerland) and sometimes at the state level (general sales tax in the USA).

Table 30

## Assignment of tax competences in selected federal competences, 1988

	Customs duties	Personal income taxes	Corporate taxes	VAT or general sales tax	Excises or selective sales, tax on oil, tobacco, liquor	Wealth and property taxes
Australia	Exclusive at federal level 7%/100%	Exclusive at federal level 57%/100%	Exclusive at federal level 13%/100%	Exclusive at federal level 11%/100%	Exclusive at state level <sup>1</sup>	Exclusively applied at state level
Canada	Exclusive at federal level 4%/100%	Federal tax with provincial surcharge <sup>2</sup> 55%/62%	Competing <sup>3</sup> 13%/66%	Competing 17%/49%	Competing <sup>4</sup> 6%/26%	Exclusive at provincial level
Germany	Exclusive at EC level	Shared 37%/50%	Shared 6%/50%	Shared 33%/60%	Exclusive at federal level <sup>5</sup> 23%/100%	Exclusive at <i>Land</i> level
Switzerland	Exclusive at confederation level 5%/100%	Competing 28%/38%	Competing 7%/42%	Exclusive at federal level 3%/100%	Exclusive at federal level 20%/100%	Competing 8%/39%
USA	Exclusive at federal level 2%/100%	Competing 72%/83%	Competing 17%/82%	Exclusive at state level	Competing 7%/50%	Exclusive at state level <sup>6</sup>

N.B.: Employed terminology as defined in Section 3.1.2. The first figure in the cells of the matrix refers to the percentage share of the specific tax in total tax revenue of the federal government; the second figure pertains to the percentage share of the federal government in the total proceeds (excluding the part accruing to the municipal level) of a specific tax category.

<sup>1</sup> Payroll and vehicle registration taxes are other important financial sources of state government. Excises *per se* are exclusive at federal level level.

<sup>2</sup> Personal income taxes are of competing kind in Quebec.

<sup>3</sup> For the seven smallest provinces, corporate tax is federal with provincial surcharge.

<sup>4</sup> Liquor taxes are overwhelmingly federal, petrol taxes largely provincial.

<sup>5</sup> With the exception of some minor levies on beer.

<sup>6</sup> Inheritance and donations taxes are of a competing nature in the US, with about 75% of total proceeds accruing to the federal government.

Source: OECD revenue statistics (1990), Spahn (1993), Van Rompuy and Heylen (1984).



### 7.3.2. Supranational tax assignment criteria

Federal practice offering little clear guidance, the selection of candidates for new own resources has to be predicated on an application to the EC of the theoretical arguments reviewed earlier. This is done in Table 31, where the various criteria against which the suitability of specific taxes as sources of EC finance should be evaluated have been assembled in rows. As far as management aspects are concerned, they depart somewhat from the motives advanced in Section 7.3.1, in view of the specific institutional and limited staff constraints the EC level of government operates under.

The two principal criteria, the existence of a cross-border externality or of a regional arbitrariness problem, refer to the economic motives for shifting tax competences upward.

The first of the secondary criteria relates to the progressivity of tax candidates. It would be helpful if supplementary EC own resources would exhibit a neutral or progressive profile. Admittedly, any unwanted properties to this effect can be offset by differentiating per country the share of the tax proceeds accruing to the Community or by applying a discriminatory key to national contributions under the current fourth resource, but such compensatory measures are rather delicate from a political point of view.

The two subsequent criteria, visibility and lack of political friction, are more political in nature. Greater visibility of EC revenue by virtue of a direct link to individual taxpayers is desirable as it enhances the democratic accountability of Community public finance. Visibility is highest in the case of taxes that noticeably affect a large number of economic agents. Lack of political friction relates to the likely reaction of national authorities to the idea of the Community sharing the proceeds or the base of a certain tax. One would expect Member States' opposition to be less when the proposed own resource concerns a levy on a base that is not (yet) tapped by the national fisc, as it does not imperil, at least not directly, national public revenue. Friction is also likely to be minor in the event of a transfer to the supranational level of public sector income that is not perceived by the electorate as resulting from a tax.

The final two tax assignment yardsticks, ease of collection and size of revenue, are of a more narrow public finance concern, but are of clear relevance for the EC budget given the institutional and regulatory constraints which the latter is subject to.<sup>1</sup> As the Community does not have its own tax

<sup>1</sup> It may be noted that the list of criteria does not include any reference to the stabilization properties of possible EC taxes. However, so long as EC deficits or surpluses are ruled out, these properties or lack thereof are basically immaterial.

**Table 31**

**Suitability of tax categories as EC own resources**

	Labour in- come taxes	Capital income	Wealth taxes	Corporate taxes		VAT	Excises	Seigniorage	Carbon dioxide taxes
				on profits	on cash-flow				
Principal criteria									
Cross-border externality	—	+ +	+	+	+	0	0	0	+ +
Regional arbitrariness	—	—	—	+	+	—	—	+ +	+
Secondary criteria									
Progressivity	+ +	0	+	0	+	—	— —	—	—
Political visibility	+	+	—	—	—	+	+	—	+ +
Lack of political friction	—	+	—	—	0	+	—	+	+
Ease of collection	—	+	— —	—	0	0/—	—	+	+
Size of revenue	+ +	—	—	+	0	+	+	+	+
Overall appreciation	—	—/0	—	0/+	+	0	—/0	+	+ / + +

Legend: ++ Very suitable as an EC own resource.  
+ Suitable as an EC own resource.  
0 Neutral, not applicable or no information.  
— Not suitable.  
— — Not at all suitable.

services, it is dependent for the collection of its revenue on national or lower levels of administration, entailing a standard principal/agent problem. The easier it is to monitor and control the collection activity, the more this problem is reduced. As the acquiring of new own resources is unavoidably a laborious political process, which ought therefore to be infrequent, it is desirable that any additional source of finance be of significant size relative to EC budgetary needs and that, unlike the traditional own resources, its proceeds in real terms do not exhibit a long-term erosion trend.<sup>1</sup>

### 7.3.3. Suitability of specific tax categories

The present section examines to what extent the most important tax categories or those that are frequently mentioned as being suitable as sources of EC finance conform to the criteria just listed. A summary picture is provided in Table 31, which offers a qualitative assessment of the relative merits of the taxes represented in the columns. For the sake of brevity, this examination will not be exhaustive: if a certain tax is found to fail to meet several criteria, its fulfilment of other criteria will not be discussed.

As indicated in the first column of the table, the economic case for entitling the Community to a part of labour income taxes is weak. As long as the Community workforce does not grow strongly mobile internationally, the scope for a downward spiral of tax pressure owing to fiscal competition is minor. Tax base apportionment problems related to border workers can be settled by a systemic application of the residence principle of taxation and bilateral agreements between the countries concerned. Although a Community share in direct taxes on individuals' earnings would sharpen citizens' awareness of the EC budget, it is very likely to meet with resentment on the side of national authorities as income taxes will become increasingly the 'hard core' of Member States' fiscal autonomy, given that the elbow-room in the indirect tax field has been circumscribed by supranational rules.<sup>2</sup> Income tax rules vary widely between countries as regards the definition of the base, mirroring divergent value judgments on social, educational, family, environmental matters, etc. In the absence of a harmonized base, EC tax

sharing or surcharges in a uniform fashion throughout the Community is bound to give rise to serious inequities on the basis of nationality, which would be amplified by national discrepancies in the administrative room for manoeuvre relative to the delineation of taxable and non-taxable income. In sum, and despite recommendations by other writers on EC public finance, labour income taxes appear inappropriate as an EC own resource.<sup>3</sup>

It was pointed out in Section 4.1.2 that because of the very high degree of international mobility of the base, the proper taxation of income from financial assets necessitates Community, arguably even OECD or worldwide, measures. Capital income taxes form the area *par excellence* for beggar-thy-neighbour competition through the favourable treatment of non-residents, driving effective tax pressure down to nil and causing cross-border delocalizations in the financial services sector as well as substitution effects between financial products. It should, however, be stressed that for an economic union to function well, taxes on income from financial assets, just like on income from labour, need not be identical nor even be closely approximated. What is crucial instead is that Member States dispose of all the necessary information to tax residents' income correctly, irrespective of where in the Community or the world it is collected. Community measures should therefore ideally take the form of an obligation for EC banks to report income collected by non-residents to the latter's national tax administrations. With a reporting requirement, the arguments just raised against labour income taxes as an EC own resource carry over to the capital income tax field.

A common minimum withholding tax at source on EC non-residents was proposed by the Commission as a second-best measure, in view of the impossibility of obtaining unanimous agreement on the reporting requirement rule. As this proposal brings out the notion of EC resident for capital income tax purposes, it might be advocated assigning the proceeds of this withholding tax on non-residents to the Community. Although such transfer would probably not meet with major political obstacles since it would be directly linked to a supranational measure and be a welcome substitute for the rather unconventional situation of personal income taxes accruing to the source country, it would be ill-suited as a Community own resource. For one reason, the revenue from this withholding tax threatens to be very small, with non-residents' financial assets either being repatriated or shifted to tax havens outside the Community upon its introduction. Second, its year-on-year fluctuations could be highly unpre-

<sup>1</sup> Moreover, on account of the balanced budget rule and the current reliance on multiannual expenditure planning through the so-called 'financial perspectives', an additional commendable trait of any EC tax is that its revenue be more or less stable and predictable with a fair degree of accuracy at least one year in advance. The recourse to a residual own resource, constituted at present by national GNP contributions, will fluctuate accordingly unless two unexpected outcomes cancel out. gyrations in the reliance on GNP contributions could upset the pursuit of national budgetary objectives, possibly linked to the compliance with excessive deficit rules.

<sup>2</sup> See Spahn (1993b).

<sup>3</sup> For example the proposal put forward in Biehl (1990) towards the introduction of an EC surcharge on national personal income taxes.

dictable because of the very speed and ease with which assets can be moved across borders, setting the stage for rapid shifts in the location of capital income collection following changes in market sentiment about future tax legislation.

The foregoing arguments suggest that the Community is not well-placed to draw on personal income as a source of revenue. This observation is also applicable to net wealth taxes, which are levied in several, principally northern, Member States. Freedom of capital movements undermines the effectiveness of wealth taxes at the national level with wealth holders transferring their mobile assets to other countries or changing residence altogether. This is the standard externality case for centralizing tax competences.

However, beside the fact that in federal practice wealth taxes are typically levied by subcentral levels of government, the administrative difficulties it involves are tremendous.<sup>1</sup> A tax is imposed on a stock, instead of a flow, which must be assessed annually for the innumerable types of assets possessed by individuals. Aside from the significant collecting and recording costs this engenders, it poses very complex valuation problems since for many assets there are no market prices. A supranational wealth tax would only compound these difficulties. For one thing, the unavoidable administrative tangles will make the principal/agent problem keenly felt; for another, in order for the valuation to be fair, it would need to take place across countries in order to account for differences in the cost of living.

As documented in OECD (1991) and the recent Ruding report (1992), effective corporate tax rates vary significantly between Member States on account of differences in the definition of the tax base, statutory rates, the fiscal link between firm and shareholder (the so-called system of imputation) and the rules on double taxation relief regarding income from cross-border activities.<sup>2</sup> Furthermore, corporate tax pressure on outward and inward investment is, on average, considerably higher than that associated with domestic investment, pointing to important internal market imperfections still existing in the corporate tax field. If the fiscal treatment of profits differs according to the location of the investment or the nationality of the investor, resource allocation in the Community as a whole is likely to be

distorted.<sup>3</sup> The sparse empirical evidence available as well as the results of the survey conducted by the Ruding Committee suggest that multinational companies' decisions on where to locate an investment and how to finance it are indeed influenced by corporate tax considerations.

Despite these sensitivities to differences in the fiscal burden, corporate tax competition between Member States has until now by no means been strong, as can be inferred from the fact that there has been a noticeably upward trend in corporate taxes as a percentage of GDP over the last two decades. Furthermore, there are good economic arguments to believe that unbridled competition in the company tax area is not likely to erupt in the future either.<sup>4</sup> Even so, a competitive tax erosion process cannot be ruled out altogether since, unlike wage earners, firms can be expected to step up considerably their cross-border mobility under the impetus of EMU. The externality criterion for centralizing tax competences can therefore be seen to be broadly applicable.

The second criterion, the existence of a regional arbitrariness problem, will also be increasingly fulfilled in the corporate tax area because of the ever larger number of firms displaying a multinational dimension and the rise in the complexity of intra-firm transactions. This evolution will expand the scope for artificially shifting profits across borders by internal over- or under-invoicing, or the judicious financing of foreign subsidiaries or allocation of overhead costs. Such abusive transfer pricing or thin capitalization practices can be com-

<sup>1</sup> See Spahn (1993b).

<sup>2</sup> National differences in the effective rate on the marginal investment project have, however, tended to diminish in the recent past, chiefly as a result of the downward convergence of inflation rates.

<sup>3</sup> When two enterprises operating in the same Member State are subject to a different tax treatment because the parent company happens to be located in another Member State, so-called capital-import neutrality is violated: European resources may not be put to best use as a less efficient producer may carry out a project because an intrinsically more efficient company is taxed more heavily. So-called capital export neutrality is violated when the choice of Member State to invest in is influenced by company tax rules. If a firm would prefer to invest in Member State A rather than in Member State B but after taking account of differences in corporate tax pressure it decided to invest in B, a Community welfare loss would result since production does not occur at the lowest cost prior to taxes. See Devereux and Pearson (1989).

<sup>4</sup> Basically two arguments can be advanced that make cut-throat competition unlikely even if firms displayed a high corporate tax sensitivity. First of all, the incentive to engage in tax cuts is not clear as their effectiveness depends largely on how other Member States treat foreign source income. For example, lowering the net fiscal burden with a view to obtaining more foreign direct investment is futile when foreign countries operate a residence-based tax regime. Second, even though corporate tax revenue is relatively unimportant — corporate taxes represent in the EC on average 2.8% of GDP and 7.1% of total tax revenue — such that a large reduction would not have large direct budgetary consequences, the indirect budgetary impact could be considerable as it puts downward pressure on personal income tax rates in order to reduce incentives facing taxpayers to shelter personal income in the corporate sector. See Vanheukelen (1991), pp. 289-290.



bated through case-by-case arbitration panels<sup>1</sup> but any of the responses that are systemically more satisfactory as they remove the fiscal incentive for firms to engage in transfer pricing,<sup>2</sup> involve the adoption of largely arbitrary rules on how to partition among Member States multinational enterprises' taxable income.

Economic conditions appear therefore united for recommending the establishment in the medium term of a single corporate tax regime characterized by a harmonized tax base, a minimum statutory rate and a common country-apportionment formula relative to the profits of enterprises operating in more than one Member State.

It is, however, worth emphasizing once more here that the case for centralizing tax competences is to be distinguished from that for the assignment of revenue to the central level of government. A major reason why Member States will probably strongly object to the idea of corporate taxes as an EC own resource is that the latter are connected with the national personal income tax regime through the rules on relief for double taxation at shareholder level. An EC tax on corporate profits would face tremendous administrative and fairness problems unless this link is severed, i.e. unless relief at the shareholder level is repealed.<sup>3</sup> But the chances of this happening look minor as it would impinge pervasively on Member States' fiscal regime relative to capital income in general.

In addition, company taxes may not do very well in terms of political visibility. It may notably reinforce the impression of public opinion that the Community is first and foremost a business matter.

However, as demonstrated in Spahn (1993b), corporate taxes would become much more appealing as a Community own resource if they were levied on firms' net cash flow in lieu of their profits.<sup>4</sup> The merits of cash flow taxation or expenditure taxation in general need not be repeated here as they

have been dealt with at length in the public finance literature.<sup>5</sup> However, its additional advantages in the present context should be underlined. To start with, the obstacle arising from the link with personal income taxes would be overcome as cash flow taxation does not allow for imputation relief. Second, as the taxable base is much more straightforward to compute, collection of the tax and its monitoring should be relatively easy. Furthermore, cash flow taxes will display a progressive profile inasmuch as private investment activity is stronger in developing than in economically more mature regions. The most important drawback of cash flow taxes as an EC own resource is that the revenue they generate may be rather limited, with net tax receipts resulting purely from the realization of 'excess' profits.

It will be recalled that about half of present Community revenue is associated with value-added taxes. However, as explained in Section 7.1, this revenue does not derive directly from an EC charge on consumer purchases but is collected from national authorities by means of a notional harmonized base, the nature of which is further removed from tax reality as a result of the capping procedure. Chiefly on account of its regressive characteristics it was recommended earlier to supplant the present VAT resource by national contributions on the basis of GNP. The question to be addressed here is whether a share of or a surcharge on actual national VAT would be a suitable candidate as a new own resource.

From a political visibility point of view this would look an attractive option, as VAT permits a close link with Community citizens and the familiarity of the EC's involvement in it will tend to reduce objections by national authorities.

However, once rules on VAT have reached their final phase as envisaged by the Commission, the economic case is rather weak. The permanent VAT regime, to be established before the end of the decade, will be characterized by minimum rates on a broadly harmonized base, as well as by the application of the origin principle for tax collection and the destination principle for eventual tax receipts. With VAT on intra-EC exports no longer zero-rated and revenue accruing to the country of final consumption, a clearing mechanism will be called for to undertake cross-border VAT transfers between national fiscs. Under such a regime, the absence of border controls should not give rise to any serious externality problems or regional arbitrariness difficulties. The remaining scope for microeconomic distortions arising from cross-border shopping will be confined geographically to border re-

<sup>1</sup> These arbitration panels have been provided for in the July 1990 Convention concluded by Member States on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

<sup>2</sup> Such as European unitary taxation, or the application of the 'pure' residence principle with a clearing mechanism.

<sup>3</sup> This repeal could take the form of either generalizing the classical system (no relief) or by uniform relief at the corporate level by levying a lower tax rate on distributed dividends.

<sup>4</sup> The cash flow tax base is measured as the difference between the receipts from sales of goods and services and the purchases of all real goods and services, including capital goods, required in the production process. The major difference with the profit taxation would be the granting of immediate exemptions for all forms of investment and interest payments would no longer qualify as a deduction. Dividends would be treated as under the classical system.

<sup>5</sup> See for example Meade (1978), Bradford (1980) or King in Padoa-Schioppa (1987).

gions and to certain product ranges. On the other hand, the deployment of a central clearing house operating on the basis of actual transactions offers the technical means of apportioning accurately Member States' claims on VAT revenue, whilst closing loopholes of tax evasion.

The management by an EC agency of the clearing house would make it possible to monitor part of EC taxes due, but for the collection of VAT on purely domestic goods and services one would have to rely totally on the effectiveness of national administrations. Finally, with EC revenue emanating directly from consumption purchases, the regressive profile of VAT will be more pronounced than under the current third resource.

Leaving aside levies on fossil fuels, which will be dealt with in the discussion of carbon dioxide taxes, most of the foregoing remarks on VAT are equally valid, if not more so, for excises.

In the prospective final regime on excises, there will be minimum duties on all alcohol, tobacco and hydrocarbon products. Unlike the collection procedure envisaged for VAT, excisable goods destined for exports will be exempt from duties and handled through a system of bonded warehouses. Duties only become applicable once the goods leave the bonded warehouses in the country of destination. Provided that minima are fixed high enough that total price differentials do not trigger massive cross-frontier purchases of liquor and tobacco, this double-destination regime for excises should be able to absorb well the disappearance of border controls.<sup>1</sup> Assigning excises to the supranational government is therefore hard to uphold on economic grounds.

Furthermore, excises at EC level would have an even stronger regressive incidence than VAT, because their revenue elasticity with regard to GNP is low, and high with respect to rate increases.<sup>2</sup> Political sensitivities at Member State level are not to be underestimated either. Excises reflect closely a society's value judgments on the consumption of goods with health risks, which forms part of the explanation for the limited progress registered so far in the fixing of minimum levels.

With the exception of the cash flow corporate tax, whose introduction is not on the political cards for now, all potential sources of finance reviewed hitherto fail to fulfil one or more important criteria contained in Table 31. The last two types of taxes to be examined do appear, however, highly suitable as future own resources of the Community.

<sup>1</sup> It should be remarked, though, that maintaining exemption for exports upon the removal of border controls, reinforces, *ceteris paribus*, the incentives for smuggling and counterfeiting fiscal tags.

<sup>2</sup> See Spahn (1993b).

The first concerns the seigniorage of the future European System of Central Banks (ESCB).

The greater part of the revenue of a central bank stems from its monopoly position as issuer of liabilities carrying no remuneration (in the case of banknotes) or one below the market rate of interest (in the case of compulsory commercial bank deposits). These liabilities make up the monetary base. Seigniorage, or income of monetary origin, is the return on interest-bearing assets forming the counterpart to the monetary base.

With the entry into Stage III of EMU, the Community's single monetary policy will be conducted by the ESCB, composed of the European Central Bank and the present national central banks (NCBs). A large part of currency will continue to be issued by NCBs and commercial bank reserves against deposits will be kept with NCBs, such that each NCB will have as a liability a certain share of the ESCB's aggregate monetary base. However, much like in the case of customs revenue, a 'correct' distribution of seigniorage among the Member States is very hard to make, the more so as part of it will derive from the holding of ecus by third-country residents.

The chief reason is that, because the EC's monetary base will have become an indissoluble whole, the part held by an individual NCB is unlikely to reflect accurately the volume of cash balances and reserves held by resident individuals and banks, as high powered money issued by any one NCB is legal tender in all other EMU members. More fundamentally, any monetary policy operation and exchange market intervention affecting the EC money supply will have repercussions in the interbank market and thus lead to a reallocation of the monetary base among NCBs. As it results from a truly common policy, ESCB seigniorage forms, from an economic point of view, a first-best own resource for the Community, especially once the banknotes and coins of the 12 national currencies have been taken out of circulation.<sup>3, 4</sup>

<sup>3</sup> It should be mentioned in this regard that central bank shareholders other than the union authorities should not necessarily receive their full share of central bank profits. Since the right to issue high-powered money is a privilege conferred by the state, the proceeds belong in principle to the State. This argument is well-reflected in the practice of federal countries, including the USA and Switzerland where, from a legal point of view, State monetary institutions issue currency or hold all shares in public hands. In the USA, where the federal government is not a shareholder of any of the 12 Federal reserves, virtually all of net earnings is transferred to the US Treasury. In Switzerland, compensation to the cantons for the loss of their issuance right was gradually phased out in real terms.

<sup>4</sup> ESCB seigniorage as an own resource could pose some problems in the event that the monetary union would not comprise the whole of the Community, i.e. if one or more Member States would not participate in the final stage of EMU.

Table 32

Illustrative example of the evolution of seigniorage income to GDP 1989-98

Central bank	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Belgium	0,64	0,75	0,72	0,68	0,65	0,60	0,56	0,51	0,46	0,46
Denmark	0,42	0,46	0,42	0,39	0,36	0,32	0,29	0,25	0,22	0,22
Germany	0,68	0,86	0,78	0,71	0,64	0,57	0,51	0,45	0,39	0,39
Greece	2,44	2,33	2,09	1,85	1,61	1,37	1,14	0,90	0,67	0,67
Spain	2,02	1,88	1,66	1,46	1,26	1,07	0,88	0,71	0,54	0,54
France	0,49	0,55	0,51	0,47	0,44	0,40	0,36	0,32	0,28	0,28
Ireland	0,52	0,58	0,56	0,54	0,51	0,47	0,43	0,39	0,34	0,34
Italy	1,25	1,29	1,15	1,01	0,87	0,74	0,61	0,48	0,36	0,36
Luxembourg	0,10	0,11	0,13	0,15	0,16	0,16	0,17	0,17	0,16	0,16
Netherlands	0,64	0,79	0,75	0,70	0,65	0,60	0,55	0,51	0,46	0,46
Portugal	3,42	3,57	3,04	2,54	2,07	1,63	1,22	0,85	0,50	0,50
United Kingdom	0,28	0,34	0,34	0,33	0,32	0,30	0,28	0,26	0,23	0,23

Underlying working hypotheses:

1. Steady state reached in 1997.
2. Banknotes to GDP ratio held constant at 1989 value.
3. Interest rate on money base proxied by capital market rate (short rate in Greece). Declines linearly to 5% in 1997.
4. Reserves from banks in the EC converge to 2% in 1997 on a representative broad money aggregate.
5. Interest rates on remunerated reserves converge to zero by 1997.
6. Ratio of representative broad aggregate to GDP held constant at last known level.
7. Exchange rates fixed at the ecu central rate following UK entry for 1990 and subsequent years (except for Greece and Portugal whose rates depreciate by Nominal GDP growth minus 6% until they join the ERM (assumed to take place in 1994 in Portugal and 1997 in Greece).
8. Nominal GDP growth rates converge linearly to 5% by 1997. Thereafter constant.
9. The May 1990 change to reserves in Spain was assumed counterfactually to have been in place throughout 1990.

Source: BIS.

Being an implicit tax, seigniorage suffers from an almost complete lack of visibility (except in times of high inflation), but this very nature will make it presumably much less controversial for national politicians to transfer this type of revenue than an explicit levy.

At least as far as the next 10 to 15 years are concerned, the order of magnitude of seigniorage would fit well the Community's prospective increase in finance needs as outlined in the previous chapter. Total seigniorage amounted in 1989 to about 0,65% of EC GDP. As obligatory bank deposits will have come down towards the levels in the countries without capital controls, nominal interest rates will be identical throughout the union and lower than today's average, and more efficient payment systems will have been installed in the less developed Member States. Hence, seigniorage in Stage III is likely to fall short of the present level. On plausible assumptions elaborated by the BIS — which do not account for the probable surge in ecu holdings by third-country, especially Eastern European, residents — Table 32 shows that total EC seigniorage can be expected to shrink by the end of the century to about 0,4% of EC GDP.

Because of these probable developments during the transition period, moreover, the regressive characteristics of cur-

rent seigniorage can be expected to have vanished to a large extent at the time of the move to Stage III.

Finally, seigniorage would also be a convenient own resource from the viewpoint of the management of revenue collection. Monitoring should be relatively swift, as only 13 agents are involved, the ECB and the 12 NCBs.<sup>1</sup>

The search for new own resources is rounded off by assessing the suitability of environmental taxes, and more specifically of the revenue from taxes, or pollution permit auctions, to curb the emission of carbon dioxide (CO<sub>2</sub>). As indicated in the final column of Table 31, it turns out that on virtually all counts this revenue would qualify very well as a source of Community finance.

Concern for the protection of the environment has risen significantly over the last few years. One area that has increasingly become the focus of attention at the international level is the risk of drastic climatic change due to

<sup>1</sup> Incentives need to be sought that motivate NCBs to manage efficiently the assets forming the counterpart of their share of the common monetary base and to keep their operating costs in check. A possibility could be to leave a certain percentage of the return on its assets. Care should be taken, however, to ensure that seigniorage considerations do not in any serious way influence the conduct of monetary policy.

the heightened concentration of greenhouse gases, more than half of which is caused by carbon dioxide.<sup>1</sup> The overwhelming majority of carbon dioxide emissions stem from the combustion of fossil fuels: coal, oil and, to a lesser extent, natural gas. The Community has set itself the task of stabilizing CO<sub>2</sub> emission by 2000 at the 1990 level, representing a reduction of between 10 and 15% compared to the baseline scenario.<sup>2</sup>

There is a growing consensus that to achieve this goal, market-based instruments should play a central role, because of their economic efficiency. These instruments can basically take on a dual shape: on the one hand, taxes, which fix the price of emissions, leaving the volume of pollution to market decisions; on the other, tradable emission rights, fixing the total permissible volume of pollution and leaving the price per emission to the market. Given the fact that the Community has adopted a quantitative target, pollution rights' auctioning would seem quite an appealing option from a theoretical point of view.<sup>3</sup>

It was pointed out previously (Section 4.1.2) that when the effects of polluting activities spill across borders, such market-based instruments need to be harmonized at Community level<sup>4</sup> since otherwise they will be set at a suboptimal level of stringency. In fact, for this harmonization to yield an efficient outcome, it should result in total uniformity throughout the Community, because marginal costs of emission reduction ought to be identical in all Member States.

However, not only are there sound reasons for putting in place uniform market-based instruments to internalize the externality, there exists also a clear economic case for assigning the ensuing revenue to the supranational level of government. Carbon fuel taxes could be incorporated in national excises but a serious drawback of this tax method could be that it would only affect final energy consumers and not, for example, electricity producers turning on non-nuclear power stations. A better way, albeit more compli-

cated from an administrative point of view, would be to levy the CO<sub>2</sub> tax directly on primary energy producers or importers. But this would give rise to a serious regional arbitrariness and fairness problem if the proceeds from the tax — or the auctioned permits — remained with the source country. In analogy with the Rotterdam effect as regards customs duties, there would arise, so to speak, an Aberdeen or Groningen effect.

CO<sub>2</sub> levies or permits as a Community own resource would also score well on political grounds. In the wake of the 'greening' of public opinion, they are likely to be accepted without difficulty by the electorate, in particular if they were compensated by cuts in other tax areas. Also, as a levy on the carbon content of fuels (on top of existing excises) would form in most countries a new source of income, Member States would probably not reject the idea of revenue sharing with the Community, although the likelihood of their objecting would increase if the compensatory tax reductions would fall upon them.

Table 33 offers a picture of the current levels of CO<sub>2</sub> emissions in the Community and of the tax revenue a USD 10 per barrel carbon tax would yield. The revenue estimates exhibit an upward bias as they are static and therefore do not account for the decrease in carbon fuel consumption by firms and households following the rise in energy prices. However, in the short run this overstatement is probably minor with the price elasticity of energy consumption estimated to be around -0,2. The mechanical computations underlying Table 7.6 suggest a USD 10 carbon tax would generate about 1,1% of GDP. Obviously, with total EC expenditure mounting over the next 10 to 15 years to perhaps 2% of EC GDP on the one hand, and an expansion of the current fourth resource as well as the attribution of seigniorage on the other, total CO<sub>2</sub> revenue would be likely to exceed Community financial needs by a wide margin. Excess revenue should then be handed over to the Member States on the basis of a tax-sharing arrangement.

As to equity, the carbon dioxide levy looks slightly regressive, although the picture is by no means simple as the CO<sub>2</sub> intensity of an economy is the outcome of a multitude of factors such as the share and technological level of the industrial sector in economic activity, climate, the price of energy, the input mix of electricity generation, etc. Spain would contribute less than average, Greece and Ireland clearly more. In order to correct for this imbalance, one could contemplate using carbon dioxide emissions per unit of GDP as the distribution key in the tax sharing arrangement, or even a progressive key conditioned on local public finance measures — tax incentives or direct spending — to boost energy savings or CO<sub>2</sub> reductions, which would am-

<sup>1</sup> Besides, carbon dioxide is a 'key' pollutant as its emission is usually combined with the emission of other gases (CO, NO<sub>x</sub>, SO<sub>2</sub>) with negative environmental consequences.

<sup>2</sup> In its October 1991 communication, the Commission proposed a combination of a CO<sub>2</sub> tax with a general energy tax where the energy component should not exceed 50%.

<sup>3</sup> The rationale for tradable permits is that each polluter buys the right to emit a certain amount of CO<sub>2</sub>. With each permit holder comparing the cost of reducing emissions with the benefits of selling his permit, the market sees to it that emissions are reduced where this is least expensive.

<sup>4</sup> Additionally, the greenhouse effect is a classic example of literally global environmental risk. Reaching a world agreement on emission stabilization targets is likely to be attained more readily if the Community speaks with one voice at the international negotiations.

Table 33

CO<sub>2</sub> emissions and 'static'<sup>1</sup> public finance effects of a USD 10 per barrel carbon tax

	CO <sub>2</sub> emissions <sup>2</sup>	CO <sub>2</sub> emissions per unit of GDP	CO <sub>2</sub> tax revenue as a percentage of GDP <sup>3</sup>
Belgium	29,1	0,21	1,47
Denmark	13,8	0,14	1,25
Germany	156,1	0,17	1,21
Greece	18,6	0,38	2,45
Spain	55,0	0,16	0,95
France	97,5	0,11	0,79
Ireland	8,0	0,26	1,93
Italy	102,8	0,13	0,89
Luxembourg	3,3	0,52	3,08
Netherlands	38,7	0,19	1,38
Portugal	10,3	0,25	1,37
United Kingdom	154,0	0,20	1,53
EUR 12	760,9	0,17	1,14

<sup>1</sup> Calculation in 'static' means that no reduction in CO<sub>2</sub> emissions is assumed upon introduction of the tax.<sup>2</sup> In millions of tons of carbon.<sup>3</sup> Production tax with exemption of non-energy use.

Source: Commission services, data relate to 1989.

ount to an implicit earmarking of the tax — or permit auction proceeds.

Lastly, as far as the managerial aspects are concerned, the collection of a levy on primary energy producers or importers would seem fairly straightforward given their limited number. Given the bulkiness of coal, oil and gas, the scope for unreported transactions does not appear substantial either. Although it has never been experimented on a large international scale, auctioning emission permits through a Community agency might prove simpler still. However, it raises the additional question — unrelated to public finance considerations — of controlling the compliance with the pollution ceiling set by the permits.

#### 7.4. Summary of policy recommendations for the short and longer-term development of own resources

Before the introduction of a single currency, own resources should seek to display overall proportionality, i.e. a coun-

try's share in Community revenue should be in line with its prosperity per capita. While the Edinburgh agreement will be conducive to this goal, full proportionality should be achieved by applying a 'proportionality ensuring' key to the current so-called fourth resource, consisting of national contributions on the basis of GNP.

The timing of recourse to additional sources of finance will be contingent on the speed of progress towards the accomplishment of economic and monetary union. In order to achieve a union-wide uniform tax regime, to forestall an unfair regional distribution of proceeds, and to establish a more visible fiscal link between the Community and its citizens, the Community should from the start be conferred with at least part of the revenue from the prospective carbon dioxide taxes or pollution certificate sales. Seigniorage associated with the single currency should accrue virtually entirely to the supranational level of government as it stems from a truly common policy whose revenue is basically impossible to apportion to individual countries in an economically sensible way. Shared taxes or EC surcharges on corporate profits or, preferably, cash flow, could form a suitable candidate in the somewhat more remote future.

## Chapter 8

### Budgetary fairness

One of the main driving forces behind the political discussion on EC public finance over the last two decades has been the question of *juste retour*, i.e. Member States' net budgetary positions and their perceived fairness relative to national income per capita.

Not only have these issues profoundly marked the course of the budget debate, they may also risk exerting a negative influence on the formulation of EC policies in general, with Member States keeping a constant eye on the national incidence of budgetary implications of Commission proposals, eclipsing consideration of their merits *per se*.

#### 8.1. The resource flow principle

Intense debates on budgetary fairness are by no means the preserve of the EC. In fact, they recur in all federations, where the 'distribution of benefits' from union and compensation of inequities have been a potent issue both during the union formation process and afterwards when initial budgetary flow settlements were called into question. The strained discussions about interregional redistribution among the German *Länder* following unification offers a striking recent example.

In the case of the Community, however, problems are compounded by three factors. First, as remarked in the previous chapter, the EC budget is financed through funds that are either directly transferred or collected by national governments, which heightens the visibility of imbalances and concentrates political conflict over them. Second, the strongly disparate economic position, and divergent preferences (see the 'frustration' costs alluded to in Section 3.1.1), of the Member States diminish the likelihood of the non-budgetary benefits of union being fairly shared. Third, and most fundamentally, the meaning of 'fairness' in the EC context has never been well-defined, let alone agreed, principally because the status of the Community as a 'political' or 'social' union, especially in comparison with the 'union' at the Member State level, is not sufficiently clear yet.<sup>1</sup>

Even so, the current depth of integration is such that the fairness concept has evolved well-beyond the literal *juste*

*retour* notion that Member States should receive from the EC budget what they have contributed. It seems reasonable to state that the 'resource flow' principle,<sup>2</sup> which is firmly established in all federations and stipulates that resources should flow from richer to poorer Member States, has become generally accepted by now.

However, given the lack of a more precise consensus and the fact that evidently the EC budget has to serve objectives other than equity, this report doubts whether it would be possible or desirable to give this principle a very detailed operational content or to apply it in a rigid manner.

#### 8.2. The budgetary fairness debate in the past

Although the concern for budgetary fairness is shared by all countries, it has in the past been expressed most strongly by the UK, but also by Spain and Germany. From the time of its accession in 1973, the UK has claimed it suffered from a budgetary inequity problem, which set the stage for protracted periods of negotiation between 1975 and 1984. Spain voiced its dissatisfaction about the modest level of its net receipts and demanded, with the backing of the other three cohesion countries, Treaty modifications during the 1991 intergovernmental conferences towards progressivity on the revenue side and the creation of a budgetary equalization scheme. These demands were to some extent obviated in the Treaty on European Union through the establishment of a Cohesion Fund (Article 130d) and the protocol on cohesion stating that greater account needs to be taken of the contributive capacity of individual Member States in the system of own resources. Germany, on the other hand, which has long been the Community's main paymaster, has recently been pressing for changes in budgetary burden-sharing, given the large economic transformation costs in the ex-GDR.

The nettle of budgetary fairness was grasped for a first time in 1974, after the Wilson government had singled out the EC budget's inequitable outcome for the UK as the chief item for renegotiation of the British terms of entry. Accepting the British point of view in principle, the European Council asked for the elaboration of a corrective mechanism that would be generally applicable and avoid the emergence of 'unacceptable' situations for any individual Member State.<sup>3</sup> The response to this request led to the adoption, in 1976, of what became known as the 'financial mechanism'. Under this mechanism a country was entitled to a reimburse-

<sup>1</sup> This important point is revisited in Chapter 11.

<sup>2</sup> See Reichenbach (1983).

<sup>3</sup> See Strasser (1990), p. 155.

ment of part of its excess contributions if a set of three conditions was met:

- (i) a country's GNP per capita had to be below 85% of Community average;
- (ii) the claimant's GNP growth rate should not be higher than 120% of Community average;
- (iii) the country's share in Community revenue should exceed its share in Community GDP by at least 10%.

The financial mechanism thus displayed a number of noteworthy traits. First, budgetary fairness considerations could only be invoked by relatively poor countries. Second, it was designed to deal with problems of excessive contributions, and not of insufficient receipts. Third, corrections were made by way of reimbursements rather than through supplementary expenditure in favour of the country in question.

In the event, the mechanism was never activated because, of the three countries which had been expected to be eligible, Ireland and Italy continued to be net beneficiaries, whilst the strong appreciation of sterling pushed the UK over the 85% threshold.

As this mechanism did not bring any relief, a second compensation scheme was deployed by the European Council in 1979. It differed from the former mechanism in that it provided for special measures for the UK, in the form of increased Regional Fund outlays benefiting Britain. Moreover, the annual level of compensation was not fixed by a clear, predetermined set of parameters, but it became the result of frequently bitter negotiations in the Council of Ministers.

In order to stop the annual recurrence of such a budgetary bargaining process, which consumed a disproportionate amount of political energy, it was agreed at Fontainebleau in 1984 to introduce a new UK-specific compensation mechanism, this time operating a correction at source. The 1984 accord was prolonged in 1988 and again in 1992, so that it will remain operative to 1999 inclusive. It provides for the refund to the UK, by way of a reduction in the UK VAT base, of 66% of the difference between the UK's percentage share of VAT payments and its percentage share of allocated Community expenditure, applied to total allocated expenditure.<sup>1</sup>

<sup>1</sup> It is to be noted that although the formula governing the rebate remains unchanged under the Edinburgh accord, its value for the UK diminishes on account of the decreasing importance of the VAT resource in total EC revenue.

Given the emphasis on cohesion in the revised Treaty, it was natural that the Edinburgh agreement was strongly shaped by budgetary fairness considerations. Its execution will significantly improve the four lagging countries' net budgetary position, which for Ireland and Greece, two clear beneficiaries of CAP expenditure, could grow to more than 8% of local real income. However, in order to avoid a too abrupt adjustment for the others, especially Italy which looks set to become a net contributor, this quarter equity in the budget will emerge only gradually.

### 8.3. Alternative approaches to ensuring budgetary fairness

The Community's endeavours to date to cope with budgetary inequity situations have thus been pragmatic, searching for specific solutions as the need arose.<sup>2</sup>

However, in some cases, such as the UK compensation settlements during the early 1980s, this pragmatism verged dangerously towards 'ad hocery' and horse-trading. In order to avert this danger, the idea has been regularly advanced that there should be a set of corrective, 'below the line' balancing operations that would be triggered automatically and applied uniformly in the event of an emerging equity problem. The most elegant elaboration, so far, of this idea can be found in the Padoa-Schioppa report,<sup>3</sup> which recommended the creation of an equity safeguard mechanism assuring that for each individual country a certain predetermined standard of net transfer fairness was attained. By means of a precise formula, whose parameters would need to be fixed in a political negotiation process, a fiscal progressivity curve would be established, mapping the agreed inverse relationship between net balances and real income per head. Around this curve there would be bands forming the edges of the safeguard mechanism. If a country's net budgetary position were to fall outside the bands, the mechanism would prompt balancing payments to or from the EC budget until that country's position was brought back to the edge of the band.<sup>4</sup>

<sup>2</sup> As a matter of fact, this approach was also pursued relative to country-specific claims in the context of enlargement, as exemplified by the integrated Mediterranean programmes (in favour of Greece, Italy, and France) on the eve of the Spanish and Portuguese accessions, and the industrial support programme (PEDIP) for Portugal.

<sup>3</sup> Padoa-Schioppa report, pp. 104-108, and Annex D.

<sup>4</sup> In a bid to introduce macroeconomic conditionality, the Padoa-Schioppa report advocated exempting lagging countries enjoying a too generous budgetary treatment from the refunding obligation provided they committed themselves to the pursuit of national macroeconomic and public finance adjustment policies.

Once the Council had settled the vital and therefore politically highly sensitive technical details on the method of allocating for each country every revenue and expenditure item, the composition of the formula and the width of the band, such a balancing mechanism would, by virtue of its *ex ante* transparency, defuse any incipient row on budgetary burden-sharing and thereby remove a stumbling block to sound Community policy-making.

Such an equity safeguard mechanism would possess the systemically attractive characteristics of clarity and uniform applicability.

Although these advantages are undisputed, the serious problem with any sort of budgetary balancing procedure is that it begs several fundamental questions about the notion, the measurement and the method of correction of perceived budgetary inequity.

#### (i) The notion of budgetary inequity

The *juste retour* question expressed in narrow budgetary terms is ill-conceived as it ignores the much wider, and arguably more important, costs and benefits of Community membership, which transcend the strict economic dimension. If net public finance transfers formed the overriding factor, the economic or political consequences of EC membership would, for most countries, be trivial. It should be underlined here that the Community delivers a broad variety of 'public goods' benefits for the Member States, ranging from the internal market and monetary union, over common policies in the areas of competition, energy, environment, etc. to an enhanced role in world affairs. Because of the joint benefits it allows, the Community budget can by no means be seen as a zero-sum-game for all 12 countries together. The value of these non-budgetary benefits is very difficult to estimate by country, but, as remarked earlier, they cannot be assumed *a priori* to be spread equitably.

#### (ii) The measurement of budgetary inequity

Any net budgetary balancing mechanism is predicated on the hypothesis that Community revenue and outlays can be allocated on a country-basis. It turns out, however, that even if one limits the analysis to the strictly budgetary incidence of Community taxes and transfers, apportionment is more complex than appears at first sight.

In attempting to calculate net budgetary incidence, customs duties and agricultural levies are at present apportioned to the Member State collecting them. This gives rise to the so-called 'Rotterdam' effect, explaining to a large extent the

apparently high contributions from Belgium, the Netherlands and Ireland, which often form the point of entry for goods consumed or processed elsewhere in the Community. For want of information on the eventual destination within the EC of extra-EC imports, the proceeds from customs duties and other import levies cannot be attributed by Member State. By the same token, as demonstrated in Ott (1987), export refunds, claiming about one third of CAP spending or some 20% of the total budget, display the mirror image of the 'Rotterdam effect': they are recorded as accruing to the country where the goods leave the Community, but that Member State is not necessarily where the agricultural goods were produced. Obviously, it is the country of the original producers that is to a large extent the ultimate beneficiary of the budgetary intervention. Here again, statistical information is lacking, and the completion of the internal market can only add to this problem. Finally, allocating between Member States the benefits of aid to the rest of the world, whose importance — as recommended in this report — should increase to about 30% of the total budget, is also bound to be largely arbitrary.

All in all, 25% of revenue and 40% of expenditure are hard to apportion on a national basis.

#### (iii) Pitfalls of 'below the line' corrective flows

The idea of a net equity safeguard scheme is that Member States deviating unduly from their 'fair' position would make or receive compensatory payments to or from the budget. Balancing operations of this kind may, however, create problems of their own.

Unless a wide enough range of acceptable net budgetary outcomes for a given level of real income per capita relative to the EC average were permitted, a Member State's interest in the conduct of specific policies could strongly diminish, especially if, because of an inequitable position, it were entitled to refunds in the balancing operation. However, the wider the margins of acceptable outcomes, the less meaningful an equity safeguard mechanism becomes.

The reason for this likely decline in interest is that such refunds are tantamount to unconditional block grants. For a lagging Member State, the latter may look politically more attractive than, say, an expansion of the conditional and matching grants of the Structural Funds. More generally, an automatic equity safeguard mechanism would operate along much the same lines as an income-based horizontal fiscal equalization scheme, whose introduction was judged in the previous chapter to be premature at the current stage of integration.



### *Preventing pronounced imbalances*

An automatic corrective mechanism can at best come to grips only partially with the foregoing three questions. Furthermore, given vested interests and the nature of decision-making in the Council, one may doubt the political feasibility of a radical change in approach to the net equity safeguard mechanism.

Formulating a satisfactory response to perceived budgetary inequity turns out to be an exercise in a second-best world characterized by strongly imperfect information and incentive problems. It should therefore be realized that an ideal situation is very hard, if not impossible, to arrive at.

These observations do, obviously, not remove budgetary fairness concerns. Accordingly, a strategy based on the flex-

ible application of the resource flow principle which would prevent the occurrence of pronounced inequitable positions but at the same time leave enough room for negotiations to determine the precise level of redistribution and the specific problems of Member States, would appear the 'least bad' approach. For such a strategy to be effective, a high level of union loyalty ('Bundestreue') is required on the side of all partners, as the dividing line between flexibility and 'ad hocery' or arbitrariness is often a fine one. At any rate, the long-term evolution of the budget as recommended in previous chapters, including proportionality on the revenue side, a shift from product to producer support under the CAP, expansion and further reform of the Structural Funds, and a rise in aid to third countries, would achieve the prevention of pronounced imbalances. Indeed some may argue that the Edinburgh agreement, with its clear redistributive profile, sufficiently accommodates reasonable equity concerns already.

## Chapter 9

### Loan instruments in EMU

Having charted the desirable course of EC expenditure and revenue over the next 15 years, attention is focused presently on an often overlooked dimension of Community public finance, namely borrowing for on-lending, and/or the provision of supranational loan guarantees. It merits separate treatment because these instruments, which require reforms on managerial grounds, also need to undergo profound changes with the advent of EMU.

This chapter first summarizes the economic rationale of loan instruments. Second, it provides a bird's eye view of the Community's past and present loan activities as well as an appraisal of them. Subsequently, a brief assessment is offered as to how the relative efficiency of loan instruments will be affected by EMU. The ensuing policy recommendations are formulated by way of a conclusion.

#### 9.1. Loans versus grants

The economic case for use of loan instruments hinges on capital market imperfections. If capital markets were efficient, i.e. if they evaluated on the basis of all available information the credit-worthiness of borrowers or the expected return of projects in a correct fashion, it would be pointless for the Community to resort to loan instruments. The correction for cross-border externalities, stabilization support, or the pursuit of redistributive goals should then take the form of outright grants or of present discounted value equivalent loan subsidies. It follows that Community intervention in this area should preferably be geared as a general rule to financial product innovation or risky ventures, since this is where imperfections are likely to occur most frequently.

The Community can circumvent the problem of unduly high borrowing costs or credit rationing owing to financial market inefficiencies by acting itself as an intermediary, passing on the benefits of its credit reputation through on-lending, or by guaranteeing debt, thereby lowering the primary lender's risk to virtually nil. The improvement of financial conditions for the eventual borrower does not come, however, without costs. As explained in Kuhlmann (1993), it entails a financial and administrative burden for the Community and may spawn distorting side-effects in capital markets. The financial burden arises from the fact that unless intergenerational equity concerns are ignored and future European taxpayers are left to settle any shortfalls, provisions need to be made against the risk of failure of redemption. The administrative

onus, consisting chiefly of the human resources tied up in the necessary investment banking operations, cannot be totally overlooked either.<sup>1</sup>

On the other hand, in view of the sizeable volume of loans taken up by Community institutions, placing them among the largest single issuers of debt on international capital markets, the influence exerted by direct Community borrowing and lending, or loan subsidies for that matter, on competition in financial markets should also be recognized. A loan carrying a Community guarantee or interest subsidy is very attractive for banks as it permits them to expand their activities without incurring the degree of risk attached to other lending options. If the issuance of such loans or bonds is not disclosed *ex ante* such that the associated advantage can be auctioned, a discrimination emerges between banks. Similarly, and much in the same way as for public enterprises in any other sector that are not under pressure to realize the normal market return on assets, direct Community loans complicate the business of private banks, unless they are restricted to vacant financial product niches.

In sum, the potential drawbacks of Community borrowing and lending subscribe well to the general notion advanced earlier that public intervention raises welfare only to the extent that the inevitable costs of government failure do not exceed benefits from correcting market failure.

#### 9.2. The past and present use of Community loan instruments

##### 9.2.1. Concise factual overview

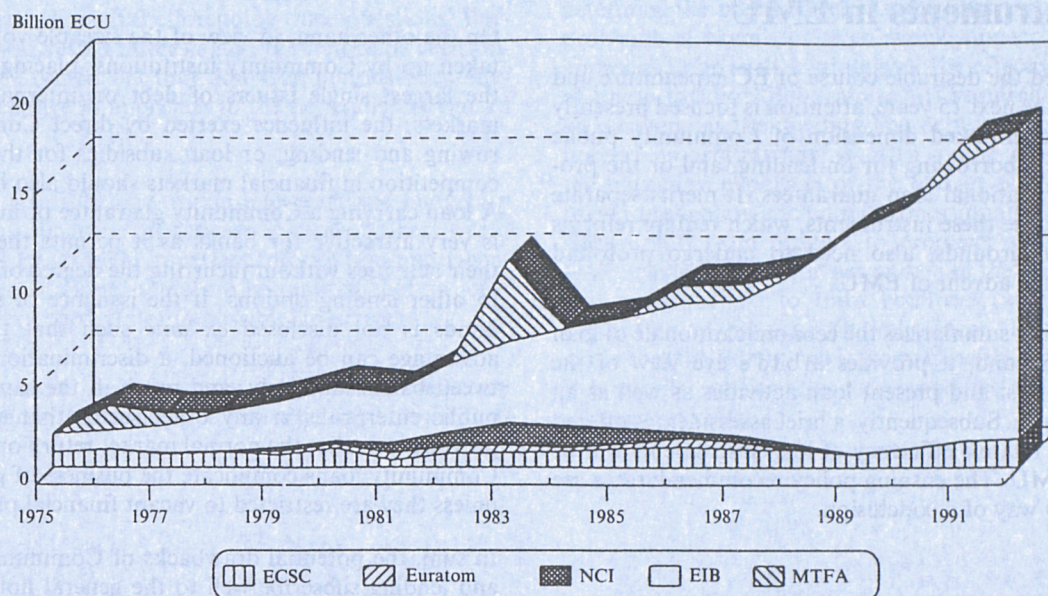
An extensive set of loan instruments has developed over the 40 years since the creation of the Coal and Steel Community. The various instruments on offer differ as to their nature (loans, guarantees, interest subsidies), their purpose (micro- or macroeconomic) and their institutional framework (legal basis, institution in charge). The following catalogue is organized around the micro-macro dichotomy and will ignore the EC's loan activities in third countries, although it should be remarked that their usefulness is often strongest there.

##### *Loan instruments with a microeconomic objective*

The aggregate evolution of the volume of outstanding loans and subsidies for microeconomic purposes since the second half of the 1970s is portrayed in Graphs 7 and 8.

<sup>1</sup> The EIB and Commission employ about 800 staff for borrowing and lending activities. The EIB charges a flat 0.2% mark up to cover operating costs.

GRAPH 7: Loans 1975-92



The development of the Community loan activity (disbursed loans) can be seen from the graph above. The graph shows that overall Community loan activity has grown considerably over the last 27 years. EIB operations largely account for this. In 1990 the EIB accounted for nearly 93 % of all Community loan operations. The graph below gives an overview of the interest subsidies paid out. The different categories are described in the main text.

In 1992, this volume stood at more than ECU 15 billion, of which roughly 95% was accounted for by EIB operations. Essentially four different intervention channels can be distinguished:

(i) ECSC loans, guarantees and interest subsidies

The Treaty of Paris empowers the Commission to undertake loans for on-lending with a view to supporting restructuring and reconversion in the coal and steel industries. Subject to some relatively general provisos, it also allows for loan guarantees, to which interest subsidies also may be attached.

(ii) European Investment Bank loans

Created in 1957, the EIB finances up to 50% of long-term investment projects. Its task, as laid down in the Treaty of Rome (Articles 130 and 130b), is basically twofold: the first runs parallel to the interventions of the Structural Funds and concerns support to projects in lagging and industrially declining regions; the second is to finance investments of interest to one Member State<sup>1</sup> or to several, 'which are of

such size or nature that they cannot be entirely financed by the various means available in the individual Member States'. This last clause is usually interpreted as a precondition pertaining to local financial market imperfection.

The risk the EIB incurs in its lending operations is minimal because its loans are almost invariably guaranteed by national authorities or by another Community institution. As a result, it has since its establishment not yet been obliged to write off a debt. EIB loans do not in principle benefit from interest subsidies.<sup>2</sup> Italy is traditionally the EIB's largest client, absorbing close to ECU 4 billion or 30% of credits in 1990. Spain and the UK each accounted for 15%.

(iii) Euratom loans

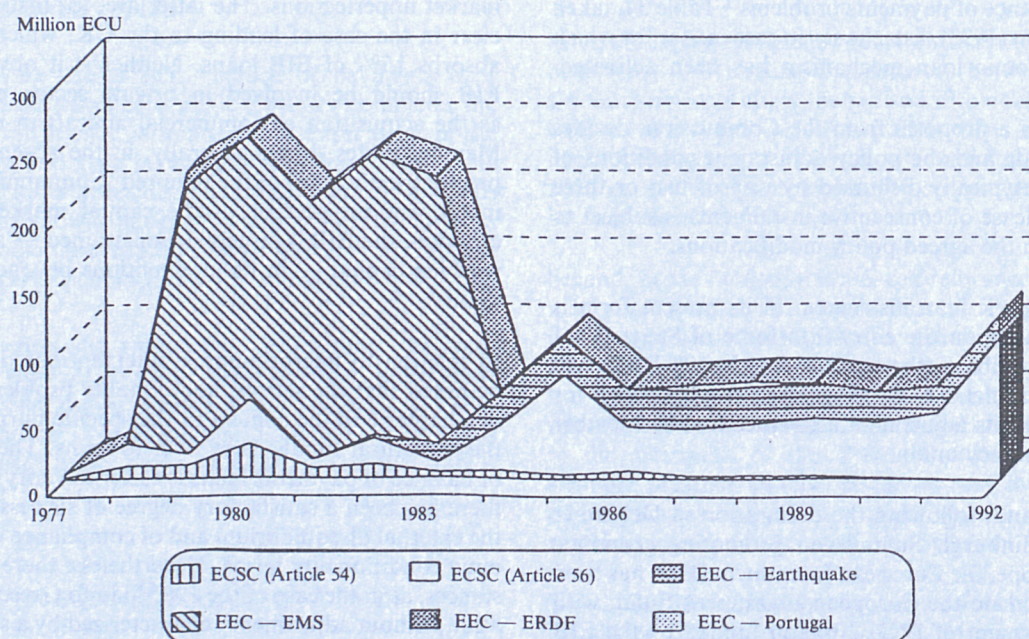
Under the Euratom Treaty, the Community can borrow to finance research and investment in nuclear energy. The EIB administers the loans.

<sup>1</sup> '... undertakings called for by the progressive establishment of the common market' (Article 130).

<sup>2</sup> The reconstruction loans in the aftermath of earthquakes (Italy in 1980, Greece in 1981 and 1986) form an exception to this rule. Subsidies are paid out of the general EC budget.



GRAPH 8: Interest subsidies, 1977-92



Source: Commission services.

## (iv) New Community Instrument (NCI) loans

Created for a first time in 1978, the NCI (also known as the Ortolí facility) was conceived as an anti-cyclical policy instrument in that it was designed chiefly to stimulate investment.<sup>1</sup> However, under subsequent NCI tranches, the allocative aspects have become preponderant with support specifically geared to small and medium-sized enterprises.

In all four cases, loans play an overwhelming role, with the requisite resources being borrowed directly on capital markets. They are mostly guaranteed by the general EC budget, for which no fee is charged, and no provisions made.<sup>2</sup>

*Loan instruments with a macroeconomic objective*

The current mechanism through which the Community offers support in the form of conditional loans to Member States with balance of payments difficulties is the medium

Table 34

## Overview of Community loans for balance of payments assistance

Year	Country	Amount (million)	Mechanism
1974	Italy	EUA 1 159,2 <sup>1</sup>	MTFA of 1971
1976	Italy (10/13) Ireland (3/13)	USD 1 100 DM 500	Community loan mechanism
1977	Italy	USD 500 <sup>2</sup>	Community loan mechanism
1983	France	ECU 4 000	Community loan mechanism
1985	Greece	ECU 1 750	Community loan mechanism
1991	Greece	ECU 2 200 <sup>3</sup>	MTFA of 1988
1993	Italy	ECU 8 000	

<sup>1</sup> European units of account.<sup>2</sup> Forms part of the loan agreement of 1974.<sup>3</sup> In three tranches: the first tranche of ECU 1 000 million was disbursed in April 1991.

<sup>1</sup> The subsidized loans in 1979 to Italy and Ireland connected with the launching of the EMS were provided through both the NCI and the EIB channel.

<sup>2</sup> This practice will continue during the period covered by the Edinburgh agreement since the foreseen loan reserve concerns lending to non-EC countries only.

term financial assistance (MTFA). Established in 1988, it merges into a single mechanism the two previously existing facilities for balance of payments problems.<sup>1</sup> Table 34, taken from Papaspyrou (1993), lists the seven cases so far for which this macroeconomic loan mechanism has been activated.

The Council, on a proposal from the Commission, decides on the magnitude and the policy adjustment conditions of the loan. Being typically disbursed by way of two or three tranches, the release of consecutive instalments is subject to compliance with the agreed policy modifications.

The macroeconomic loan instrument in its present form is due to disappear upon the entry into force of Stage III of EMU, as its legal base (the current Article 108 EEC) will have become defunct, i.e. there will be no further call for balance of payments adjustment assistance for the Member States in the currency union.

On the other hand, following the declaration in December 1992 of the Edinburgh Summit on promoting economic recovery in Europe, the European Investment Bank has been empowered to create the European Investment Fund, with an initial endowment of ECU 2 billion funded by the EIB itself, the Commission and national financial institutions. The EIF is designed to boost economic activity by facilitating the financing of so-called trans-European networks and small and medium-sized enterprises, in particular by providing loan guarantees, but also through equity participations.

### 9.2.2. Appraisal

The broad picture that emerges is one of diversity, but also one of lack of clarity and delimitation. Often, new mechanisms have been set up in response to specific political or institutional constraints, resulting in overlaps and a rather haphazard array of instruments.<sup>2</sup>

This sprawling development is understandable from a political vantage point, as loans offer strong visibility and leverage at low or zero budgetary costs, except when defaults occur, in which case the burden is passed to future taxpayers. However, lack of coherence is bound to weaken seriously both the effectiveness and the efficiency of loan instruments,

the more so as their actual use does not appear to conform well to their economic *raison d'être* associated with capital market imperfections. The latter are, for instance, far from clear in the case of lending to the UK, which nevertheless absorbs 15% of EIB loans. Neither is it obvious that the EIB should be involved in private sector projects, such as the acquisition of commercial aircraft in relatively rich Member States. More generally, in the absence of a more precise specification of the required 'Community' content of investment projects or of the capital market inefficiency criterion, the EIB is largely unconstrained — apart from its working capital — in its interventions beyond its cohesion remit.<sup>3</sup>

In relation to microeconomic interventions, it should also be noted that the serious additionality problems dealt with in Chapter 6 in the context of the specific purpose grants of the Structural Funds carry over to loans. The effectiveness of balance of payments loans is easier to verify and generally there has been a satisfactory degree of success in redressing the external disequilibrium and of compliance with the economic conditionality terms. Nevertheless, there were also instances, as in the case of the 1985 loan to Greece, of 'stabilization without adjustment', characterized by a swift improvement of the balance of payments, unaccompanied however by real progress in the fundamentals driving the external balance position such that the performance of the country in question relapsed after some time.

### 9.3. The effect of EMU on financial market imperfections

As argued in Chapter 6, the allocative, stabilization and redistributive tasks emanating from EMU call for a strengthening of the Community's financial capacity. Inasmuch as the supranational contribution to the fulfilment of these tasks includes EC loans for microeconomic or macroeconomic purposes, EMU should in principle bolster the role of Community borrowing and lending operations.

But there are probably much more powerful factors at work in the opposite direction. By enabling a truly single capital market, EMU can be expected to reduce greatly the usefulness of Community loan instruments. Once the effects of the measures towards the elimination of national barriers to financial services' markets have made their full impact, private agents as well as public authorities in all Member States should have access to the entire width and depth of the Community's banking market. The financial market imperfections that currently may still exist in one or more lagging

<sup>1</sup> This was the medium financial assistance set up in 1971, operating on credits from other Member States, and the Community loan mechanism created in 1975 in the wake of the first oil crisis.

<sup>2</sup> A number of examples may illustrate this. Both the EIB and the ECSC can finance industrial reconversion. Investment in power stations may attract support on different terms from the EIB, the ECSC and Euratom depending on the source of energy input. Both the EIB and the NCI can extend advantageous loans to small and medium-sized enterprises.

<sup>3</sup> Kuhlmann (1993), p. 15.

country therefore will be largely overcome. Accordingly, the Community will increasingly become only one of a variety of alternative providers of funds.

Besides removing the explicit balance of payments constraint, the introduction of a single currency completes the single market for finance, with interest rates on assets of the same maturity and risk being fully equalized across the Community. This is a decided advantage as the experience in the EMS has shown that even if nominal exchange rates are fixed *de facto*, and capital free to move, (real) interest rates do not converge completely for a long time.<sup>1</sup>

As a consequence, the traditional motivations for Community loans look set to evaporate over time, quite apart from the excessive deficit considerations which, it was suggested in Section 6.1, raise doubts about the use of loans under the financial assistance mechanism for regional stabilization.

#### 9.4. Recommended directions of reform

The prospect of EMU, the disappearance of the need for the balance of payments assistance mechanism, the expiry of the ECSC Treaty in 2002 and the virtual depletion of the funds available under the latest NCI tranche are all factors inviting a sweeping overhaul of the Community's loan instruments. Such an undertaking clearly lies outside the scope of the present report, but given the wider public finance perspective in which the use of loan instruments ought to

be discussed, it can offer a number of policy suggestions. They can be summarized in four points.

First, managerial efficiency demands that the distribution of borrowing and lending competences between the various Community institutions be revised. Provided that the links between the Commission and EIB were strengthened, it might be advocated assigning all loan instruments to the EIB, as it enjoys a comparative advantage in investment banking expertise.

Second, in the light of the reduced relevance of loan instruments in EMU, the EIB should shift the focus of its activities and step up considerably its efforts in third countries. There, its credit reputation could play an invaluable role, against the backdrop of the huge capital needs for modernizing infrastructure and the reluctance of financial markets to lend in the aftermath of the Third World's debt crisis. This stronger presence in third countries may lower the quality of the guarantees the EIB receives, against which it should make provisions for non-performing loans.

Third, EIB operations in the relatively rich Member States should be diminished accordingly. More specifically, they should be circumscribed by a very strict interpretation of the notion of cross-border externalities and capital market imperfections.

Finally, the EIB's involvement in the Community's lagging regions ought to move in the direction of risk finance and financial engineering. The size of the EIB's reserves is large enough for even considerable risk exposure. Such risk lending should be of great help in the lagging regions where the private financial sector can be expected to remain rather reluctant to provide venture capital or similar assistance. At the same time, this move will tend to lower the EIB's potentially harmful impact on competitive conditions in capital markets at large.

<sup>1</sup> This persistent interest differential appears chiefly due to expectational errors regarding the credibility of exchange rates, which is sometimes called in the literature the 'peso problem'. See *European Economy* No 44, 'One market, one money', pp. 124-125.



## Chapter 10

### Streamlining budgetary procedures and control

The changes in supranational competences to accompany EMU not only entail a need for modifications in the overall size of the Community budget, the pattern of expenditure, financing arrangements, and borrowing and lending operations. It also calls for adjustment of the budget procedure and management methods.

Due to the loss of, or constraints on, several micro- and macroeconomic instruments at the national level arising from EMU, and economic upheavals or political turmoil which presently characterize large parts of the rest of the world, the Community budget should become more flexible and able to respond swiftly to emergencies, and this without jeopardizing the pursuit of its normal policy priorities. At the same time, especially in view of the stress laid by an increasing number of Member States and the Maastricht Treaty on national public finance orthodoxy, budget flexibility has to be reconciled with a meticulous observance of budgetary discipline.

Of course, the gradual rise in EC spending and 'own resources' as advocated in previous chapters may not go down very well with public opinion, stiffening national political resistance, if the Community is not seen to be making its best efforts to improve budget execution and control. Media stories of fraud, waste, and unchecked irregularities with respect to the CAP, aid to third countries, the Structural Funds, and so on, place the Community under fire from friend and foe alike. Such stories tarnish the EC's reputation and make any new integration proposals look premature. It is therefore important that the Community be given the instruments to put its financial house in order.

Questions of budgetary procedure, execution and control are usually rather technical, displaying often more legal and administrative aspects than economic ones, and requiring a lot of specific expertise. As a detailed discussion was felt to transcend the remit of this report, the present chapter does not aim at providing an exhaustive treatment of these questions. Instead, it confines its attention to arguably the two most important issues from an economic point of view: reconciling budgetary flexibility and discipline, and improving the principal/agent relationship associated with the decentralized implementation of EC policy. Throughout this chapter the institutional balance of powers is assumed to

stay unaltered. A few, inevitably somewhat political, recommendations regarding the evolution of this balance are advanced at the close of the report.

#### 10.1. Budgetary flexibility versus discipline

Since the adoption in 1988 of the interinstitutional agreement, whose renewal for the period up to 1999 is currently under discussion, the EC budget is subject to two sorts of discipline. Aside from the prohibition on running a deficit, effectively setting the ceiling on 'own resources' (as an overall spending constraint) which can only be altered upon the consent of national parliaments, there is the additional limitation emanating from the multiannual 'financial perspectives' plan, fixing the yearly real growth of the EC's chief expenditure items.

As pointed out in Chapter 2, the principal drawback of the current procedure is that it is rigid, with little or no possibility to react to any desired shift in priorities or major unforeseen events.

The weakness of this procedure, which at the national level would be unduly onerous and restrictive, is, however, also its strength in the Community context. Given the unavoidably confrontational relationship between Council and Parliament vying for budgetary power, a five or seven-year consensus on policy priorities translated at the outset into key financial parameters enables budgetary 'peace' and a steady evolution of Community spending, thereby promoting coherence between annual budgetary decisions and the medium-term outlook. The positive aspect of the 'financial perspectives' strait-jacket is its predictability, which is a valuable asset especially in the framework of ambitious longer-term projects like the internal market or EMU calling for accompanying 'positive integration' measures with a significant budgetary incidence.

Furthermore, the rigidity and balanced-budget handicap should not be overplayed. Given that Community objectives in the allocative and redistributive domain have sufficiently crystalized to be cast in five-year programmes, the need for policy switches and deficit spending would essentially relate to the field of stabilization. But, as argued in Chapter 4, the EC budget is far too small to exert a meaningful anti-cyclical influence on the Community as a whole.

The great difficulty for the EC budget to respond to contingencies does need to be remedied, however. Events that are hard, if not impossible, to predict arise mainly in relation to short-term assistance to third countries, regional stabilization support (see Chapter 6) and calls on loan guarantees.



As they are beyond the control of the budget authority, the outlays they occasion should be covered by one or several reserve funds for well-delineated purposes. Such reserves could be incorporated into the general budget so long as they do not correspond to a sizable portion of ordinary expenditure. If they do, they should be managed outside the budget, because, in line with usual accounting principles, the Council will consider the theoretical maximum and not the average or historically highest amount of spending from the reserve funds, when verifying the compatibility of total expenditure proposals with the own resources ceiling. Included in the general budget, large reserve funds thus would hamper the growth potential of ordinary expenditure items.

By creating separate reserves for, on the one hand, emergency relief outside the Community and loan guarantees to third country borrowers on the other, the Edinburgh agreement goes some way towards meeting the foregoing concerns. However, compared to the situation between 1988 and 1992, the overall room for budgetary flexibility will actually diminish in the years ahead. Whereas in the previous period there was a 0,03% of EC GDP margin for responding to unspecified contingencies, in conjunction with an ECU 1 billion reserve for covering the rise in agricultural expenditure caused by unexpected dollar/ecu exchange-rate fluctuations, the 1993-99 financial perspectives plan provides for a margin of increase of 0,01% only, while the global magnitude of reserves hardly expands. Anxious to keep the rise in the own resources ceiling to a minimum, Member States have opted for a future squeeze on the scope for flexibility. Under such tight circumstances, budgetary crises, and the costs of inefficiency that go with them, may prove difficult to avoid.

Discipline should be the overriding concern of EC budget procedures. However, it is still too early to pronounce upon the effectiveness of the interinstitutional agreement as an instrument of budgetary control.

In the 1988-92 period, the 'financial perspectives' were respected without great difficulty because economic growth was stronger than expected, CAP spending grew modestly (at least initially) and expenditure ceilings had generally been set rather generously. It remains to be seen whether the agreement will perform better under unfavourable circumstances than the failed attempts at discipline made prior to 1988 when the Council flouted constraints it had imposed itself.

It would seem that as long as the problem of overruns is not tackled at the root and no strict, legally enforceable, link is established between the decisions with regard to the budget and expenditure-intensive policies, derailments cannot be

ruled out. This holds especially in respect of the CAP where vested interests are well-organized, and spending is open-ended and inherently difficult to control, notwithstanding the 'early warning system' designed to ensure the observance of the agricultural spending constraint.<sup>1, 2</sup>

## 10.2. Improving decentralized budget execution and control

As it is neither possible nor desirable (see Chapter 3) for the Commission, the body responsible for the execution of the budget, to manage and control directly the various expenditure, revenue and transfer systems in support of Community policies, the day-to-day implementation of the budget relies on varying forms of shared management between the supranational, national and regional tiers of government.

As set out in the literature on the principal/agent problem, the success of the devolution of executive tasks hinges upon three factors:

- (i) the availability of instruments allowing the principal to verify the agent's compliance with the task entrusted to him;
- (ii) the transparency and simplicity of tasks involved;
- (iii) the presence of incentives, be they positive or negative, for the agent to fulfil his role properly.

It turns out that in all three domains, the decentralized execution of the EC budget exhibits clear room for improvement.

### *Verification of compliance*

In a system of multi-layer government, there is a hierarchical set of principal/agent relationships and a corresponding chain of financial responsibility and accountability links. The EC's budgetary authority, constituted jointly by the Council and Parliament, acts as the principal on behalf of the European taxpayer. It devolves the better part of its

<sup>1</sup> See Article 6 of the Council Decision of 24 June 1988 concerning budgetary discipline (88/377/EEC).

<sup>2</sup> An important step to a durable solution could be to empower the budget ministers to overrule decisions by other Councils threatening to trespass their predetermined spending maximum. The present horizontal fragmentation of decision-making in the Council may well prove the chief institutional impediment to maintaining budgetary discipline.

'stewardship' of Community resources to the Commission, which, in its turn, relies on national and regional administrations to collect own resources and ensure that Community outlays end up with the intended recipient.

However, whereas through the EC Court of Auditors (whose role has been strengthened in the Maastricht Treaty) and the official 'discharge' decision by Parliament, the budgetary authority has potent means at its disposal to judge the management performance of the Commission, the latter is not well-equipped to control the implementation of the budget at national or regional level, especially outside the field of the CAP.<sup>1</sup>

As set out in Groutage (1993), the accountability of national and regional agencies handling EC funds is obscured because, on the one hand, the Commission appears rather reluctant in its internal audit operations to emphasize *vis-à-vis* Member States its position of superior steward by examining national execution performances and making its findings publicly known through regular reports. On the other, the Commission cannot at present rely on other public bodies for external audit assurances.

Such a role could ideally be played by national audit services, which possess the best knowledge available on Member States' public management. Drawing on national audit services, admittedly, will not be without difficulties given that they report ultimately to their own parliaments.<sup>2</sup> Counter-arguments to this problem of conflict of interest are the tradition of discipline and independence of the accounting profession as well the possibility of the Commission to carry out quality assurance checks so as to 'audit the national auditors'.

### *Rationalizing budgetary management procedures*

Aside from the foregoing insufficiency of control mechanisms, the decentralized implementation of the budget also suffers from a lack of clarity and simplicity in the guidelines to be followed or goals to be achieved by the national and regional authorities. This shortcoming gives rise to the problem of poorly specified distributions of responsibility, which typically becomes more acute as the chain of com-

mand grows longer. In particular with regard to budget items such as the Structural Funds, that have rapidly expanded and where efforts so far have concentrated on the general design and adoption of policies, precise budgetary tasks are often ill-defined.

Additionally, the complexity of procedures renders the budget liable to abuse. This dimension of 'government failure' appears a major weakness of the CAP, especially as regards export refunds. As pointed out in a recent Court of Auditors' report, procedural complexities form a prime reason why export refunds are highly vulnerable to fraudulent exploitation. Rationalization of procedures is likely to go a long way towards reducing the scope for misunderstandings, disclaimers of responsibility, and abuse.

### *Inadequacy of compliance incentives*

Defective control mechanisms and imprecise assignments need not lead to problems of implementation if the agent has a strong interest in meeting the principal's objectives. The national or regional officials in charge of making EC payments or collecting own resources do not, however, face positive incentives to carry out their task to the best of their abilities, because their paymaster is the national or regional government and the latter may not always be seriously concerned as one is dealing to a large extent 'with other people's money'. Furthermore, spending agencies usually receive the better part of their financial means from national sources, such that, understandably, their first goal is to conform with national imperatives.

As a consequence of these circumstances, Member State administrations are normally unlikely, of their own volition, to do their utmost to ensure the sound execution of the EC budget. Besides the previously mentioned recourse to national audit bodies, a satisfactory response to this lack of commitment would appear to require measures directly aimed at the responsible officials or through specific-purpose, conditional, grants to the governments in question. Unconditional grants, such as the 10% of traditional own resources Member States currently receive in compensation for the costs of collection they incur, do not seem capable of securing the intended objective: according to the previously mentioned report by the Court of Auditors, national support for customs' staffing and other organizational arrangements may well be insufficient to enable the required standards for Community controls to be met.

<sup>1</sup> In the field of the CAP, there exists a 'clearance of accounts' mechanism whereby the Commission's auditors verify that Member States' paying agencies have complied strictly with CAP regulations.

<sup>2</sup> In view of its capacity as an arm of the Community's budgetary authority, hence of its interest in the proper execution of the budget, the European Parliament could start talks to this end with its national counterparts.



## **Part D**

# **Further deepening and widening**



## Chapter 11

### Social union and enlargement to the East

The Maastricht Treaty on European Union solemnly reiterates that the peoples of Europe are creating 'an ever closer union, where decisions are taken as closely as possible to the citizens'. It thus by no means marks the end of the road, but, rather, will form the basis for yet another round of constitutional negotiations, starting in 1996, when a new intergovernmental conference will be convened.

In the economic sphere, the integration process will have entered a further important stage with the establishment of EMU. As earlier chapters of this report make clear, EMU itself can be successfully accomplished with relatively modest increases in the Community budget. While the open-ended nature of economic union will call for recurring reappraisals of the assignment of competences between the Community and national levels of government in the light of growing interdependence, there is no reason to expect that once EMU has reached its steady state, there will be any further requirement for a substantial change in Community public finances on account of economic or monetary aspects of union alone.

Instead, the development of the EC budget beyond EMU will be driven primarily by the implications of the intensification of efforts to construct a 'social' union, as well as the prospective enlargement of the Community, especially towards the East.

The purpose of the final part of this report is to explore in broad terms to what size Community public finance may need to expand in response to:

- (i) changes in the nature and volume of EC transfers in the 'social union' context;
- (ii) membership for Central and East European countries.

Before embarking on this exploration, it needs to be recalled that the EC is the first organization in history with union aspirations whose competences have been developing after the interventions of the constituent States in economic and social life had reached the degree of maturity that we have come to associate with the advent of the Welfare State. The surge in the role of central government in federal countries is a relatively recent phenomenon, beginning in the inter-war period, and has run parallel to the growth of public

expenditure in general, and of the establishment of redistributive policies and social insurance in particular. Put differently, the rise in federal outlays was not so much the outcome of a shift in powers, but rather essentially the result of filling vacant policy areas. This is totally different for the EC since there are few, if any, unexploited fields left. This characteristic, in conjunction with the systematic application of the subsidiarity principle, means that the current preponderance of the central level of government in federations, surveyed in Chapter 3, cannot be taken, even using a long-term horizon, as the normative benchmark for the evolution of the EC budget.<sup>1</sup>

#### 11.1. The budgetary incidence of defence union

Besides a number of critical changes in the institutional balance of powers, e.g. granting more legislative competences to the European Parliament, fleshing out the 'political union' goal in operational terms will mean the development of a common foreign and defence policy, as well as improved cooperation in internal security matters.

Given the fact that the conduct of foreign affairs, *sensu stricto*, costs very little (0.02% of EC GDP among all Member States), additional outlays or savings from common external representations are basically a non-issue from a macro-budgetary point of view.<sup>2</sup> The present analysis will therefore centre on the budgetary consequences of a supranational role in the Community's external security.

For more than 30 years following the breakdown in 1954 of the Plevin Plan to create a European Defence Community, no initiatives were developed to achieve a European external security policy. However, building on a long practice of informal political collaboration, initial progress was registered with the 1987 Single European Act establishing formal European cooperation in the technological and industrial aspects of security. At Maastricht it was decided that, upon the entry into force of the new Treaty, defence matters proper would no longer fall totally outside the ambit of the union. Although the latter's involvement is to be strictly

<sup>1</sup> Taking an unweighted average of column 3 in Table 6, central government spending claims more than 60% of the sum of central and state expenditure. Over half of central outlays go to health, social security and welfare. Defence absorbs about 10%, the USA being a pronounced outlier with 27%. See the statistical annex to *European Economy, Reports and studies* No 5-1993.

<sup>2</sup> A similar remark can be made with respect to the budgetary cost of elaborating a common internal security policy, more specifically of developing the recently created Europol into some sort of Community FBI. The total cost (inclusive of counter-intelligence) of the American FBI amounted to USD 1.8 billion in 1991, or approximately 0.05% of US GDP.

confined to the purely political dimension, it may be expected that over time, perhaps after the intergovernmental conference of 1996, the WEU, which currently constitutes the military coordination forum for nine Member States, will form an integral part of the union's structure. As a result, the union could become active in the military domain as well. Bringing the political and military institutions and mechanisms under one roof would bolster the credibility of the European component in the NATO framework.

As pointed out in Teutemann (1993), a supranational defence policy is economically justifiable on grounds of positive externalities — a country undertaking a large defence effort provides a deterrent to potential aggressors, which benefits neighbouring partners in the alliance — and clearly also of economies of scale and indivisibilities, as regards both procurement and the provision of military power.<sup>1</sup> Fontanel and Smith (1991) argue that common procurement will allow important gains because of the large fixed R&D costs and learning curve effects attendant with weapons production. An integrated command structure will generate greater efficiency and effectiveness as it avoids duplication of support costs and fragmentation of forces.

Due to the disappearance of the threat of a massive invasion from the East, modifications in strategic military thinking, as well as the continuous rise in the real cost of equipment for modern electronic warfare — on recent trends of the order of 7% per annum — the role, size, and composition of national armies is currently undergoing a sweeping overhaul. The fall-out from this fundamental review is likely to include, first, a sharp reduction of defence budgets so as to collect the 'peace dividend'; second, a lesser emphasis on protection against major attacks, and more on peace-keeping tasks abroad; and, third, increased flexibility and speed in interventions.

Against this background, the provision of defence on a national basis will become increasingly problematic. By contrast, a defence union could cater for a high level of military deterrence, with much less than the current ECU 125 billion, or 2,5% of GDP, Community countries spend on defence. Only such a union would be able to cushion the withdrawal of US troops from the continent.

<sup>1</sup> The provision of power exhibits indivisibilities: below a threshold, little benefit is obtained. For instance, for deterrence to be effective, at least one nuclear missile submarine must be on patrol at all times, requiring a fleet of at least four. Thus the marginal benefit of a system is zero up to a certain threshold level. Moreover, larger size has a more than proportionate effect on the probability of winning, which may be subject to a quadratic function of numbers. See Fontanel and Smith (1991), pp. 403-404.

Short of a fully-fledged defence union, which would mean a monumental change in national sovereignty, the response to the needs for peace-keeping abroad and greater flexibility and speed could take the form of the creation of a rapid deployment force under the authority of the union, which could act as a substitute for, or complement to, similar units that are currently being contemplated in several Member States.

The budgetary cost of a European rapid deployment force would obviously depend on its size and the frequency of its interventions. However, provided the logistic services of the reduced national armies are relied on, the availability of a powerful rapid deployment force could, according to military experts, be ensured with an annual budget of about ECU 10 billion per annum or 0,2% of EC GDP.

## 11.2. Completing 'social union'

As was argued in Chapter 4 of this report, new steps in the direction of 'social union', characterized by guaranteed commonly defined minimum income and/or public service levels, will be either voluntary, expressing a stronger feeling of common citizenship and solidarity, or forced, if the international mobility of people frustrates the conduct of autonomous national interpersonal redistribution regimes.<sup>2</sup>

### 11.2.1. From cohesion to equity

In the case of the former scenario, the cohesion objective underlying present interregional transfers would fade and make room for explicit equity considerations. Under such circumstances, a first major change could be a move from conditional to unconditional lump-sum transfers. The Structural Funds would essentially disappear in their current shape and be superseded by equalization grants, operating vertically, or horizontally, like the German 'Finanzausgleich'. The aim of such grants would be to equalize 'fiscal capacity' between Member States, where otherwise differences in taxable capacity or the cost of providing public

<sup>2</sup> As pointed out in Chapter 1, the other major aspect of social union is of a regulatory nature and concerns a common set of minimum rights in the area of labour law and industrial relations. It is assumed here that this regulatory aspect, the further elaboration of which will hinge closely on the implementation of the so-called social charter, does not occasion any significant direct EC expenditure.

services would preclude countries from delivering basic levels of public services at similar levels of tax pressure.<sup>1</sup>

Not only may 'social union' alter the nature of interregional transfers; more pronounced equity considerations may also set the stage for the acceptance of minimum national living standards, topping up a country's disposable income per capita to a pre-determined target level. As an alternative to the unconditional transfers just mentioned, which were associated with the notions of fiscal capacity and public service needs, one could thus also conceive of an interregional transfer scheme where each Member State below (80 or 90% of) the Community average receives a net grant such that initial income disparities are reduced by say 10% — which would still be considerably less than the 25 to 50% interregional redistribution (see Table 9) observed in mature federations.

Relative income targets contrast with the present situation in which absolute levels of transfers (in real terms) are fixed *ex ante* for a five-year period. For the sake of illustration, and on the assumption that all countries contribute to the financing in a fiscally neutral fashion, a 10% net redistributive guarantee in favour of the four lagging Member States would imply, for 1992, a gross transfer of around ECU 28 billion. This would be more than three times as high as the ECU 8.2 billion currently channelled to these countries through the Structural Funds, engendering, as shown in Table 20, a net redistributive effect of between roughly 2 and 5%.

So far, the adoption of the 'social union' objective has been argued to lay down the conditions for raising the volume of interregional transfers and making them unconditional. However, altruism being fundamentally a concern about people, equity is normally taken to relate to the reduction of interpersonal, not interregional, income disparities. As pointed out in Prud'homme (1993), interregional transfers display a dual disadvantage from this angle. They will not automatically tend to narrow interpersonal differences since poor people in rich regions may end up paying for rich people in poor regions. Similarly, aid to a region may not be used ultimately in support of the most needy inhabitants. This is why regional policies in several federal and unitary countries have been scaled down, putting greater emphasis on 'people-oriented' instruments.

<sup>1</sup> In line with federal practice, the criteria for distributing equalization grants among the lagging Member States should be laid down in a formula reflecting, first, a country's 'fiscal capacity', which is captured ideally by the size, on a uniform measurement, of the national tax base relative to the Community average, or, failing this, of national GDP per capita. The second main element in the formula should be an indicator of expenditure needs per capita, which are often taken to be a function of population density or surface/area.

These considerations are also relevant in principle for the Community, but they need to be examined beside the powerful politico-economic arguments in Pauly (1973), Forte (1977), and Tresch (1981), put forward in Section 4.3.2, against a large role for central government in interpersonal redistribution. In brief, such a role can be contemplated in earnest only when altruism has taken on so strong a European dimension that nationality has basically become irrelevant for solidarity purposes and national preferences for redistribution have closely converged. These conditions may not be fulfilled within the EC for a very long time, if ever.

Even before then, however, the supranational layer of government could play some subordinate role in the field of interpersonal redistribution. For instance, one could think of a system, broadly along the lines of King (1984), in which EC residents entitled to welfare or similar sorts of allowances would receive a European minimum income from the Community to be supplemented by national means. Apart from marking the beginning of solidarity among Europe's citizens, it would allow the Community to acquire indispensable managerial expertise for a possible more ambitious role later on.

### 11.2.2. National redistribution and the challenge of cross-border migration

The determinants of international labour mobility within Western Europe are largely unknown. However, the assumption adopted so far in this report has been that mobility will remain very limited due to cultural and linguistic factors. Furthermore, cross-border migration in the Community is by no means actively promoted.

If this hypothesis is dropped and it is instead supposed that soon in the next century mobility will increase considerably and that all EC nationals have access to the income support and social services of the Member State in which they reside, the budgetary sustainability of national redistributive schemes may be jeopardized.

When migration takes place on the basis of relative price signals in the labour market, it elicits, much like capital mobility, a beneficial effect on the allocation of resources, hence on prosperity in the union. However, when it is motivated purely by tax or transfer considerations and it takes on economically significant proportions, it can give rise to difficulties because, apart from distorting resource allocation, it may render the initial degree of redistribution within Member States no longer affordable by occasioning an 'adverse selection' problem: individuals who reckon themselves to be net beneficiaries will be attracted to the country



in question, while net contributors are repelled. This problem may arise even when countries enjoy the same level of prosperity, but choose to offer a different bundle of social benefits or to finance a similar bundle differently.

This observation has been the standard argument in the traditional fiscal federalism literature (Oates (1972), Musgrave (1968)) for assigning the primary responsibility for redistribution policy to the central level of government. However, the viability in practice of a federation like the USA, where important competences for public health, welfare and unemployment matters in spite of presumably the relatively highest degree of inter-state mobility remain at the subcentral level, as well as more recent advances in public finance theory (Boadway and Flatters (1982), Wildasin (1991a)) show that centralization is not an inevitable consequence. Neither, evidently, would it be a politically tenable one when interpersonal altruism remained strongly interwoven with feelings of national, as distinct from European, identity.

A sharp rise in intra-EC migration by no means has to lead to a wholesale shift of interpersonal redistribution to the EC level. Fiscally induced migration is tantamount to a cross-border externality and calls therefore for internalizing measures.

Accordingly, national progressive tax and social security and benefit regimes can basically stay intact, provided minimum levels of effective personal tax rates are fixed and intergovernmental grants are made available with the specific purpose of upgrading poorer countries' social protection and education and public health. In the real world, where migration arises from both labour market and tax/transfer signals, it is even possible, as demonstrated in Wildasin (1991b), that such an intergovernmental grant is also welfare-enhancing for the donor country.<sup>1</sup>

### 11.3. Enlargement to EFTA and the East

Until three or four years ago, the prospect of a large-scale enlargement of the Community did not present itself in any acute way. The only question of major significance in this

respect concerned the application by Turkey in 1987, which the Community put on hold in 1990.

Since 1989, however, historical events have succeeded one another at a tremendous pace, modifying the political map of Europe beyond recognition. One East European communist regime after another collapsed and Germany was reunited. Partly in response to these developments, but primarily because they realized during the negotiations on the establishment of the European Economic Area that staying outside would not serve their long-term economic interests well, most EFTA countries decided to opt for membership or at least to give the possibility of applying very serious consideration. Because of its political stability and economic prosperity, the Community has been propelled into an anchor-role for the whole continent, and the queue of actual and potential applicants has been lengthening rapidly.

Several reasons were invoked in Chapter 1 to justify the assumption made throughout the report that before EMU has reached its steady state, none of the countries that used to live behind the iron curtain will have joined the Community. Over the next 10 to 15 years, they will benefit increasingly from the dismantling of Community import barriers and from technical and financial aid, perhaps in a framework analogous to the Marshall Plan, as recommended in Chapter 5, but they will not become subject to the entire set of rights and obligations of the *acquis communautaire*.

All the same, it is quite obvious that the East European countries that remain faithful to democracy, human rights and a market-based economy cannot be denied access for very long, if only because the prospect of qualifying for membership has galvanized their preparedness to undergo painful reforms. Although economic adjustment is inescapable regardless of their accession ambitions, the danger of a slide-back into political and economic instability will definitely grow larger if their hopes are disappointed.

The Community's future enlargement, at first limited to the present EFTA members and countries with small populations, subsequently extending to Central Europe and, perhaps, at a still more remote point in time, the European republics of the former Soviet Union, will no doubt constitute the greatest challenge the Community has been confronted with since its creation. An increase, albeit spread over a decade, from 12 to perhaps more than 24 members will necessitate a renewed comprehensive review of the EC's tasks and decision-making process.

The inclusion of the EFTA countries should be relatively straightforward because their economic structure and level of development are similar to those in northern Member

<sup>1</sup> The model developed in Wildasin (1991b) can be used to show that, in the presence of a national redistributive policy, the net income of all those residing within a given jurisdiction can be raised by imposing taxes on them and handing over the proceeds to mobile households residing outside the jurisdiction. This result does not require any strong assumptions: it basically derives from the opportunity grants provide to limit migration to a maximum advantageous level for the host country. In other words, in a second-best environment with allocation distortions arising from domestic income redistribution, there may be 'gains from giving'.

States. Moreover, their accession should have a favourable influence on the EC budget as, under current EC policies, they stand to be net contributors. Had Austria, Switzerland, Norway, Sweden and Finland been part of the Community in 1992, they would, according to calculations in Brenton and Gros (1993), have received ECU 0,14 billion Structural Fund transfers (by virtue of Objective 5b) and close to ECU 2 billion in CAP subsidies. To this should be added their participation in other EC policies, which, on the assumption of a 10% incremental effect, would have occasioned outlays of another ECU 850 million. However, with forecast extra revenue of around ECU 6,4 billion, the net positive outcome would have been in the region of ECU 3,7 billion, thereby creating significant supplementary leeway within the constraint of the own resources ceiling. The entry of EFTA countries in 1995 or shortly thereafter should considerably facilitate compliance with the budgetary commitments made at Edinburgh.

The Community's enlargement to the East will unavoidably bring about a shift of emphasis in Community policies, also, if not largely, due to the budgetary implications. The latter are obviously quite impossible to foretell with any degree of accuracy, as it is unknown which countries the EC will eventually comprise, what will be their income level and economic structure at the time of accession, and how Com-

munity policies will have evolved by then. However, they are liable to pose a major challenge, in particular if by that time agricultural reform as outlined in Chapter 4 has not been brought to a successful conclusion.

As the Structural Funds and the CAP at present claim more than 80% of total EC expenditure and will continue to do so at least until 2000, the analysis will be confined to these two budgetary items.

Table 35 compares the EC's current 'cohesion' Member States with the countries of Eastern Europe in terms of population and relative levels of income per capita expressed in purchasing power standards. The estimates of the latter for Eastern Europe, relating to 1989 and based on OECD data, must be treated with a very high degree of caution, but they broadly correspond with casual empiricism of experts in the field. What those figures indicate robustly is that all East European countries, especially those in the Balkan area, are poorer per capita than the EC's lagging Member States. The harsh recession experienced by most of them during recent years can only corroborate this finding.

In 1992, the two least developed Community Member States, Greece and Portugal, received by way of the Structural

**Table 35**

**A comparison between the EC's 'cohesion' Member States and countries of Central and Eastern Europe**

	Population (million) (1991)	Income per capita (PPS) EC = 100 (1991)	Gross receipts from Structural Funds (ECU per capita) (1992)
Greece	10,1	52,2	182,2
Spain	39,4	80,5	89,6
Ireland	3,5	69,0	289,4
Portugal	9,8	57,1	195,7
EUR 4	62,8	71,66	132,14
Poland	38,2	36,4	
Hungary	10,6	40,5	
Czechoslovakia	15,6	45,7	
Subtotal	64,4		
Romania	23,0	23,7	
Bulgaria	9,0	32,9	
Yugoslavia	23,7		
Albania	3,5		
Baltic republics	8,0		
Subtotal	131,6		
Other European former USSR republics (except Russia)	77,6		
Total	209,2		

Funds a little less than ECU 200 per capita. As a consequence of the commitment in the Edinburgh agreement to double structural expenditure to the benefit of the four cohesion countries, the per capita support to the currently two poorest Member States should approximate ECU 400 in 1999. If it is supposed for a moment that Eastern Europe were part of the Community at the turn of the century, a ECU 400 transfer per head in their favour would seem, on current policies, a minimum in view of their relative backwardness and evident lack of modern infrastructure. Membership of the four Visegrad countries then would imply a rise in the Structural Funds of about ECU 26 billion. The additional inclusion of the Balkan and Baltic republics basically would double this rise to around ECU 54 billion, or roughly 0,85% of EC GDP as predicted for 1999. This compares with the ECU 3,5 billion per annum Eastern Europe (exclusive of the ex-USSR republics) has been receiving in the form of grants from the Twelve in 1990-92 (see Table 25) or the ECU 16,5 billion to be spent in the 'cohesion' countries through the combined channels of the Structural Funds and the Cohesion Fund in 1993. Further enlargement to the European former USSR republics apart from the Baltic States would bring the increase in the Structural Funds to a total of ECU 86 billion, or 1,3% of EC GDP, being equal to the total budget as foreseen at present.<sup>1</sup>

Massive though the impact of enlargement to the East on structural expenditure could be, the longer-term implications for agricultural spending might be even greater if the general reform measures announced in 1992 were to remain a dead letter.

Indeed, the application of the present CAP to Eastern Europe would not occasion a significant increase in EC outlays because most of the countries in question are currently net agricultural importers. The introduction of the CAP, which raises the European price level above that on world markets and thereby creams off consumer surplus, would as a matter of fact be against these countries' economic interests. It is, however, rather likely that, *inter alia* through better profit incentives and by means of the CAP's 'guidance' section, productivity in these local agricultural sectors will increase rapidly, turning around their trade position over time, the more so as, in line with Western nutritional patterns, domestic consumption of basic agricultural products will probably decline. As surplus producing countries, they would

start benefiting from the export restitutions and swell CAP spending, particularly because East European agriculture happens to be specialized in products such as milk, beef and veal, cereals and sugar, which currently claim half of CAP expenditure. Brenton and Gros (1993) estimate that if East European countries were to close half of the current gap in agricultural yields relative to areas in the Community with similar climatic conditions, the Visegrad countries would obtain ECU 17 billion in CAP subsidies, Romania and Bulgaria jointly almost ECU 6 billion, while the three Baltic republics, with a population of 8 million people but a high percentage of land under cultivation for cereals and dairy farming, would receive ECU 9 billion. Additional gains in productivity would further aggravate the bill. Moreover, because East European production is not complementary to that of the Community, the CAP's structural imbalances are liable to be reinforced. Surpluses will grow for products where there already exists an excess supply, depressing world market prices and hence the unit cost of export restitutions, whereas imports of products for which Europe is not self-sufficient will rise.

The prospect of enlargement to the East should thus act as a catalyst for a sweeping reform of the CAP from product to direct income support. Yet, if the latter were fully available to Eastern Europe as well, the budgetary consequences also could be very sizable. Although one will no doubt witness a massive exodus from the land concomitant with the modernization of agriculture, it is very likely, in the light of the current situation as shown in Table 36, that the share of agriculture in their active population will continue to be well-above the 6 to 7% level prevailing in the Community. Confronted with these unattractive alternative scenarios, the voices calling for a renationalization of agricultural policy, at least in part, look set to become louder.

The above simple calculations and arguments point to a fundamental policy dilemma the Community will sooner or later need to come to grips with. According to mainstream integrationist doctrine, deepening should precede widening, i.e. the Community has first to bring further institutional reforms to fruition and bolster its economic and social *acquis* for it to be in a position to absorb successfully a spate of new entrants. The snag is, however, that whereas this strategy is well-suited for coping with newcomers from EFTA, policies aimed at promoting economic or social union objectives, like a renewed steep rise in the Structural Funds or the introduction of fairly generous interregional equalization grants, may grow unaffordable upon the accession of the Eastern countries. Accordingly, redistributive policies may have to be scaled down over time, which may feed back negatively on the Community's functioning as it disturbs the delicate systemic balance between economic efficiency,

<sup>1</sup> Obviously, such transfers would be very major in terms of beneficiaries' real income. Even if they were to register high growth rates in the intervening period (say 5% per annum), these transfers would represent almost 10% of GDP (expressed in ecus) for the relatively richest among them, i.e. the Czech Republic, rising to about 20% for Romania. Unless basically all types of public and private investment were eligible for support, the recipient countries would not be able to absorb this volume of assistance at prevailing co-financing requirements.

stability and equity. Europe may then be whole and free, but with clearly more modest 'union' ambitions.

**Table 36**

Share of agriculture in employment and value-added, 1989

	% in active population	% in gross value-added
Belgium	2,8	2,0
Denmark	6,0	4,2
Germany (without ex-GDR)	3,7	1,5
Greece	26,6	15,8
Spain	13,0	5,1
France	6,4	3,5
Ireland	15,1	9,7
Italy	9,3	3,7
Luxembourg	3,4	2,1
Netherlands	4,7	4,3
Portugal	18,9	6,3
United Kingdom	2,2	1,0
EUR 12	7,0	3,0

	% in active population	% in net material product
Poland	27	13,0
Hungary	18	20,4
Czechoslovakia	12	10,1
Romania	28	15,2
Bulgaria	17	11,5
Albania	50	32,7

Sources: Eurostat, OECD and Economist Intelligence Unit.

#### 11.4. Institutional and political implications

The aim of this report has been to thrash out the economics of the future of Community public finance. Nevertheless, the above sketch of the probable principal developments in the EC from around the turn of the century, and their potential budgetary impact, would be somewhat incomplete if no light were shed on the institutional and political changes that should parallel them.

In fact, it would be desirable for the balanced development of the Community if the increase in EC spending and revenue that is recommended in this report to accompany the establishment of EMU, went hand in hand with an improvement in democratic accountability, i.e. with a strengthening of the role of the European Parliament in the budgetary field. This could encompass an enlarged say on expenditure by abolishing the present distinction between compulsory and

non-compulsory spending and/or relaxing the so-called 'maximum' rate of increase in non-compulsory spending, which continues to restrict severely the Parliament's room for manoeuvre. Greater democratic accountability should also mean granting Parliament some competence over EC revenue-raising.

However, the developments outlined in this final chapter are, from a political point of view, much more radical than EMU. Accordingly, they call for a much more profound overhaul of the institutional balance of powers and the decision-making process.

Proposals towards the supranational funding of a common minimum living standard throughout the Community, will stand a chance of success only if they are based on strong feelings of common identity. This enhanced degree of togetherness should find its institutional expression in a major reinforcement of the role of the body whose mandate derives directly from the people, i.e. the European Parliament.

On the other hand, it seems on the whole unlikely that the present largely intergovernmental fashion of decision-making, and in particular the still strong reliance on the unanimity requirement, will remain sustainable with a substantially enlarged membership. The danger that the Community will succumb under its own weight may then loom large.

Social union will not be acceptable without a concomitant remedying of the 'democratic deficit', whereas an enlargement from 12 to perhaps more than 20 will render the current decision-making process unmanageable. Put differently, the further 'deepening and widening' will be both cause and consequence of what could be a decisive move towards a 'federal' Europe.

Compared to the present situation, the distinctive core attributes of a 'federal' Europe would include:

- (i) Community competences that are clearly delineated in a European constitution having the principle of subsidiarity as its cornerstone.
- (ii) A European Parliament with full legislative powers, inclusive of the right of taxation and of participation in intergovernmental conferences on an equal footing with the Member States.
- (iii) The replacement of the Commission by a genuine European government appointed by Parliament, instead of the Member States. Its composition would thus reflect the prevailing political majority of the Community in its entirety.

Institutional change might encompass in addition:

- (i) The transformation of the Council of Ministers into a publicly deliberating second chamber representing the intergovernmental dimension. Aside from participating in the legislative process, the latter's main task could consist of securing where needed the coordination of Member State policies. The requirement of Member State unanimity for decisions would be ruled out, except in a number of strictly circumscribed cases.
- (ii) As an additional safeguard against undue centralization, the possibility of a referendum, subjecting vital policy

decisions and proposed changes to the European constitution to direct democratic support.<sup>1</sup>

Only when the foregoing institutional reforms have been achieved will the 'political union' project, launched at Maastricht, have neared completion.

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<sup>1</sup> Admittedly, a Community referendum would be a demanding operation from an organizational point of view, and would not correspond with democratic habits in some bigger Member States.

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# Eastern Europe and the USSR

## THE CHALLENGE OF FREEDOM

GILES MERRITT



The sparks of unrest that leapt from Berlin in November 1989 to Moscow's Red Square in August 1991 are firing an explosion of political and economic change. Out of the ashes of Communism is emerging the shape of a vast new European market-place stretching from the Atlantic to the Pacific.

In his fascinating account of Europe's fast-changing East-West relationships, Giles Merritt argues that a massive rescue operation must be mounted to ensure the success of these changes. The upheaval of Communism's collapse is 'The challenge of freedom'.

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For anyone concerned about the future of Eastern Europe and the USSR, whether from a political, social or economic standpoint, this book is essential reading.

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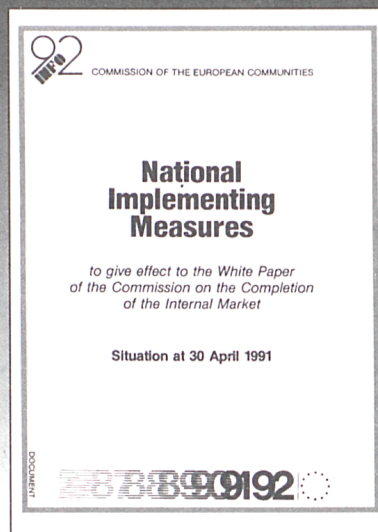
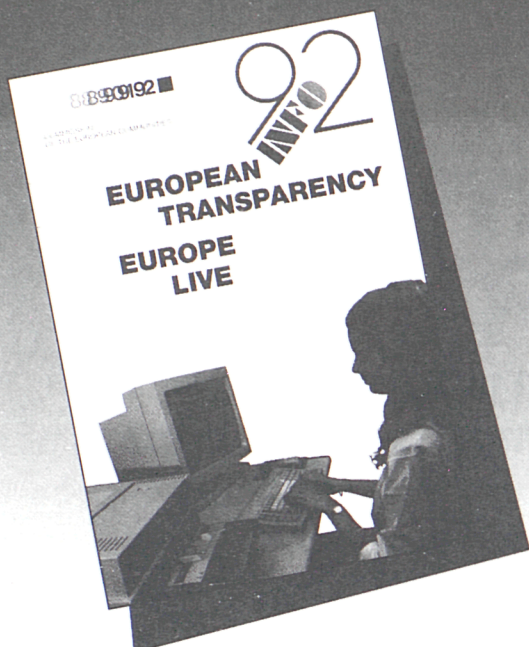
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To make Community legislation more accessible to the public, the Commission of the European Communities publishes a Directory, updated twice a year, covering:

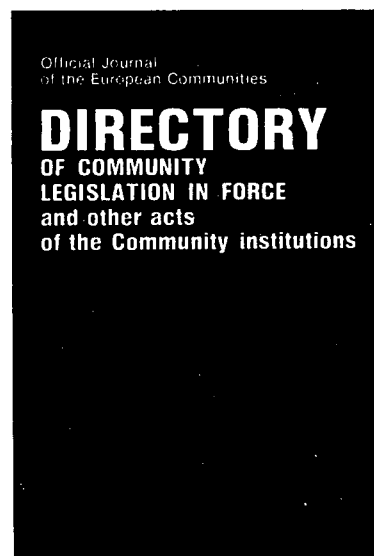
- binding instruments of secondary legislation arising out of the Treaties establishing the three Communities (regulations, decisions, directives, etc.);
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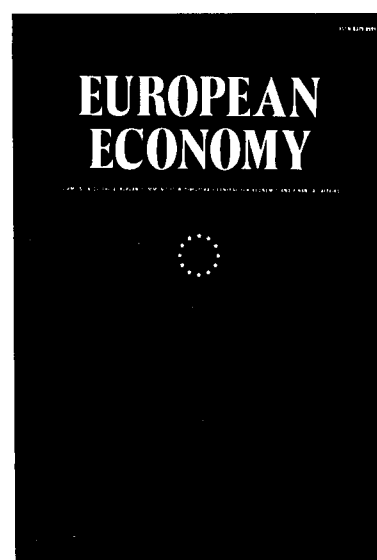
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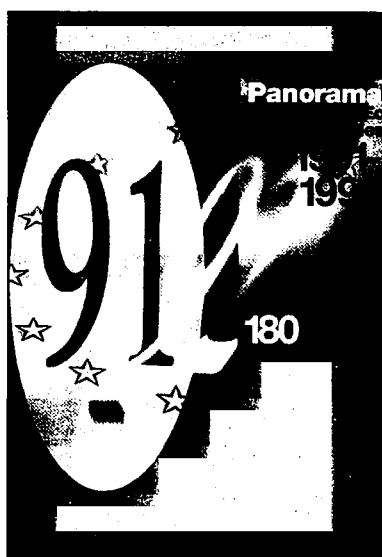
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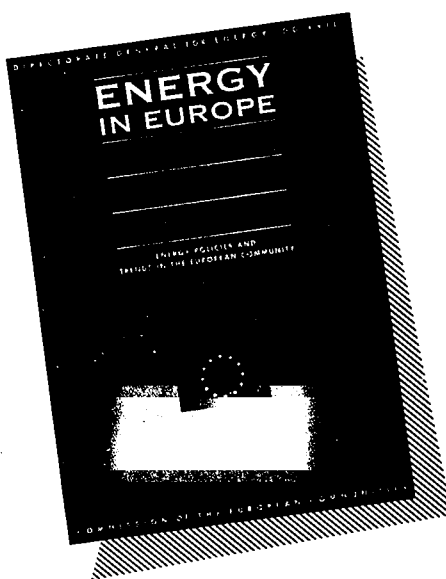
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